

# SECURITIES FRAUD ON THE INTERNET

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## HEARINGS

BEFORE THE  
PERMANENT  
SUBCOMMITTEE ON INVESTIGATIONS  
OF THE  
COMMITTEE ON  
GOVERNMENTAL AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED SIXTH CONGRESS  
FIRST SESSION

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MARCH 22 AND 23, 1999

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## SECURITIES FRAUD ON THE INTERNET

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MONDAY, MARCH 22, 1999

U.S. SENATE,  
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,  
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 1:31 p.m., in room SD-342, Dirksen Senate Office Building, Hon. Susan Collins, Chairman of the Subcommittee, presiding.

Present: Senators Collins, Levin, and Edwards.

Staff Present: Timothy J. Shea, Chief Counsel/Staff Director; Mary D. Robertson, Chief Clerk; Lee Blalack, Deputy Chief Counsel; Elliot Berke, Counsel; Kirk E. Walder, Investigator; Smokey Everett, Detailee/Secret Service; Wesley Phillips, Detailee/GAO; Linda Gustitus, Minority Chief Counsel; Bob Roach, Counsel to the Minority; Butch Burke (Senator Stevens); Michael Loesch (Senator Cochran); Felicia Knight (Senator Collins); Seema Singh (Senator Specter); Judy White (Senator Cochran); John Elliot (Senator Specter); Julie Vincent (Senator Voinovich); Nanci Langlely (Senator Akaka); Maureen Mahon (Senator Edwards); and Peter Ludgin (Senator Lieberman).

### OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. Good afternoon. The Subcommittee will please come to order.

Today, the Permanent Subcommittee on Investigations begins hearings concerning securities fraud on the Internet. The investigation that led to these hearings is the logical union of two earlier inquiries conducted by this Subcommittee.

In September 1997, this Subcommittee held hearings on fraud in the micro-capital markets, which explored market manipulation, such as "pump and dump" schemes, intended to bilk unwitting investors out of their hard-earned money. Then, in February of last year, the Subcommittee held hearings which examined various Internet scams and detailed the numerous ways in which consumers have been swindled by con artists using computers.

As more and more investors turn to the Internet as a resource for obtaining financial information, not to mention actual on-line trading, it made sense for the Subcommittee to explore the connection, if any, between securities fraud and the Internet. What we have found is that swindlers have embraced the new technologies of the Internet in order to prey on Web-surfing investors. In fact, securities frauds have moved from the boiler rooms of yesterday to the Internet chat rooms of today.

Over the next 2 days, we will hear testimony from victims of Internet securities fraud, from Federal and State regulators, the General Accounting Office, the founder of a popular on-line financial forum, and the author of the book "Securities Regulation in Cyberspace." Their testimony will examine the types of fraud perpetrated in cyberspace. They will also discuss what it is about this new medium, the Internet, that dramatically accelerates the commission of fraud and how perpetrators of fraudulent schemes infiltrate on-line bulletin boards, chat rooms, and newsletters, as well as using mass E-mails to seek out unwary investors.

I want to emphasize that we are not holding these hearings as a means of killing the messenger, so to speak. The Internet has proven to be a remarkably beneficial and revolutionary technology. It offers consumers substantially greater access to financial information and investment opportunities previously available only to industry professionals. Moreover, the securities industry has experienced notable growth due to the surge in on-line activity.

The Web, the Internet's interactive multi-media side, provides an inexpensive and convenient method for placing buy and sell orders, obtaining market information, discovering investment opportunities, and reviewing personal stock portfolios. Unlike traditional information providers, the Web does not close down at the end of the business or trading day. Recent studies suggest that nearly one-third of the 30 million American households now on-line use the Web for researching or investing in securities. In addition, studies report that some 3 million people now have on-line trading accounts, a number which is anticipated to reach 14 million people by the year 2001. Let me repeat, generally, this is good news. It is good for investors, it is good for the securities industry, and it is good for our economy as a whole.

That said, however, I am concerned that the Internet appears to be providing cybercrooks with equally profound avenues for committing financial fraud. Indeed, as *USA Today* recently reported, "1998 stood out not so much for the nature of the investment frauds as for the way that they were delivered, the Internet." The Internet often gives some consumers a false sense of security, credibility, and control regarding their investments. Some people, unfortunately, seem to believe that if they see something on the Internet, it must be true. Technology, in some cases, is mistaken for truth.

Micro-cap and penny stocks have become attractive vehicles for Internet-based scams because of their low prices and their "get rich quick" appeal. One SEC official has compared investments in micro-cap stocks to gambling. Yet, while investors might not be willing to gamble with their life savings at a Las Vegas casino, too many appear willing to place their family's nest egg in the hands of an on-line con artist illegally touting a penny stock that is "sure to become the next Microsoft or America on-line."

It is my hope that these hearings will demonstrate to what degree the Internet has changed the nature and the extent of securities fraud. We will also discuss the best way for consumers to protect themselves against these on-line scams and determine whether or not adequate consumer education programs are in place. Finally,

we will explore whether Federal and State law enforcement efforts to combat securities fraud on the Internet have been effective.

I would note as part of our consumer education effort today, these hearings are being broadcast live on the Internet today and tomorrow on the Governmental Affairs Committee's home page.

It is now my pleasure to recognize my distinguished colleague and friend, Senator Levin, for any opening remarks that he might have.

#### **OPENING STATEMENT OF SENATOR LEVIN**

Senator LEVIN. Madam Chairman, thank you and thank you for calling these very significant hearings.

The growth of the Internet as a medium for communication and commerce is revolutionizing the way that business is conducted in this country and the securities industry is no different. Today, an investor with a computer and an Internet connection has immediate access to vast amounts of information, such as company earnings, stock performance, industry trends, Securities and Exchange Commission filings, and up-to-the-minute market information. As Madam Chairman said, some opportunities that were previously reserved for professionals are now available to the average investor. That is a positive consequence of the Internet.

But along with its unprecedented volume of information and access for the average investor come concerns and problems related to fraud and market stability. The Internet is a target-rich environment for old-style frauds and for new scams. As a spokesman for the State securities regulators said, "If you are a con artist and you are not on the Internet, you should be sued for malpractice."

Using scams that have been committed through the mail and over the phone have existed for many years, scams such as "pump and dump" with con artists using those scams, and they found in the Internet a cheaper and easier way to access millions of potential targets in a very short time. It costs only about \$100 to send bulk E-mail, known as spam, to one million people. Messages can be sent in ways that disguise or hide the identity of the sender. Unscrupulous individuals can easily operate across international borders, from places where it is more difficult for enforcement officials to reach them and shut them down. Con artists can cheaply design fancy Web sites and even illegally copy authentic sites to add an air of legitimacy to their schemes.

Holding the line against fraud in a medium like this is a difficult job. Programs to combat these frauds are just getting underway, and as we will hear today from the General Accounting Office, enforcement agencies face a number of obstacles that could limit their long-term effectiveness in this area. Policing a whole new medium will put more demands on agencies that are already short-staffed. As con artists exploit the Internet to commit international crimes, apprehension and prosecution will become even more difficult and time consuming.

We need to learn whether there are additional authorities or new strategies that might enhance enforcement efforts, such as increased penalties or criminal prosecutions of perpetrators, expanded authority to bar chronic offenders from all sectors of the in-

dustry, or improved technology that would allow more comprehensive monitoring programs.

At the same time we have to address the use of the Internet for securities fraud, we also have to face the daunting challenges the Internet is creating with the use of on-line trading and day trading. With instant access to information about price fluctuations and instant access to the trading floor through the Internet for all Americans with a computer and a phone line, we face the real possibility that our stock exchanges will become more like Las Vegas and less like Wall Street. The term "blue chip stock" will have an ironic meaning, as many stocks will become chips in a poker-like trading world, where long-term investment and company development will be concepts relegated to history and minute-by-minute price changes in a virtual stock gambling casino will move the market.

There is a growing concern about the U.S. stock market as a whole, where more and more dollars are chasing a limited number of shares, where the price-to-earning ratios of stocks have risen dramatically, where the number of shares traded on a daily basis has grown exponentially over the last few decades, and where the bulk of the public's retirement accounts reside.

A certain degree of market volatility is expected, of course, but with the changes that are sweeping over the stock markets today, a significant part of which is the result of the Internet, our regulators need to move swiftly to anticipate the twists and turns that these new elements create, and on-line trading and day trading are two practices which I believe need particular attention and where we are just starting to see the problems on the horizon.

It is estimated that 7.5 million investors have on-line accounts today, and the number may grow to 18 million by 2002. The ease and lower price of on-line trading can bring more people into the market who have little or no experience and a misunderstanding of the risks involved.

But it is day trading, making dozens, perhaps hundreds of trades in 1 day, sometimes with the same stock, hoping to make profits by capturing small increases in stock prices, that raises even more troublesome issues. There are now about 40 day trading firms, with a total of 70 offices around the country, and they now account for 12 to 15 percent of the daily volume of the NASDAQ market. As this sector has grown, so have concerns about its impact on market volatility. Day traders do not buy and sell on the basis of value or growth potential of a stock. They are betting on momentum, rumor, and anything else that might enable them to capture a small rise in the price of a stock. Then they can dump it and start all over again. They are turning the most trusted market in the world into a virtual gambling casino.

If anyone thinks that this is an overstatement, I refer them to a recent article in the *Washington Post* that profiles a casino gambler who has opened a chain of day trading firms.<sup>1</sup> One of the traders at that firm put the practice of day trading this way: "Wall Street is not about investments any more, it is about big numbers. Who cares whether it is a car company or a chemical company? Who cares what they are going to be doing in the year 2000?"

<sup>1</sup> See Exhibit No. 6 in the Appendix on page 339.



Well, I do, and investors do. I know our Chairman does, because she has been taking the lead in a very large number of areas that involve consumer protection. The people who have their retirement savings in the stock market of those companies surely do, and the future health of our economy does. We have to be paying attention to this new and growing phenomenon so we do not wake up one morning and sift through the debris of a broken economy and ask, what happened?

Madam Chairman, again, I thank you for your important work in this area and so many other areas of consumer protection and I look forward to today's witnesses.

Senator COLLINS. Thank you very much, Senator.

I want to welcome the students who have joined us in the back of the room. I have a feeling that as on-line trading becomes more and more popular, that your generation will use it even more often than mine and I hope that you will learn today from the testimony you hear of some of the pitfalls if you are investing on-line or if your parents are investing on-line to help you save for your college education. So I hope today will be educational for you, as well.

I want to welcome our first panel of witnesses this afternoon. They are two on-line investors who, unfortunately, fell victim to sophisticated Internet securities fraud scams. I would note that both of them are very bright individuals. They are well educated. Each of them had considerable experience using the Internet, and I think that their experience demonstrates that even those with experience, those who are not first-time investors, for example, can be preyed upon by con artists using the Internet.

I want to thank them. I thanked them personally, but I want to thank them publicly for their willingness to come forward and share their experience. I know it is very difficult when you have been the victim of a scam to come forward publicly and share your story, but by doing so today you will help so many others avoid being ripped off as you were. So I thank you for your courage in coming forward and sharing your experience.

Our first witness is going to be Galen O'Kane. He is a constituent of mine from Ellsworth, Maine, where he lives with his wife and two sons. He is an electrical engineer by training.

Our second witness will be Mrs. Kristin Morris. She works for a computer company from her home in Berryville, Virginia, where she resides with her husband and daughter. I would note that as part of her work, working at home, she uses the Internet every day to do her job. So both of our witnesses are experienced in using the Internet.

Pursuant to the Subcommittee's Rule 6, all witnesses who testify are required to be sworn in, so I would ask that you just rise and raise your right hand. Do you swear that the testimony you are about to give to the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mrs. MORRIS. Yes.

Mr. O'KANE. I do.

Senator COLLINS. Thank you. Again, I very much appreciate your willingness to be here today. Your written testimony will be made part of the official hearing record. We are going to ask that you limit your oral presentation to no more than 10 minutes each. The

lights that are in front of you will help give you guidance as to when your time is expiring. When you have 2 minutes left, the yellow light will go on and that will give you some indication that it is time to wrap up your remarks.

We are going to start with you, Mr. O'Kane.

**TESTIMONY OF GALEN O'KANE,<sup>1</sup> ELLSWORTH, MAINE**

Mr. O'KANE. Madam Chairman and Members of the Subcommittee, thank you for inviting me to testify before you today. My name is Galen O'Kane and I am pleased to be here to testify about my recent experiences concerning a shell company portrayed as an up-and-coming technology of the future.

I am 38 years old and presently employed by Able Custom Yacht in Trenton, Maine. I graduated from the University of Maine with a degree in electrical engineering. My wife is also a University of Maine graduate, with a degree in mechanical engineering. We moved to Boston, Massachusetts, after I could not find an engineering job close to home.

My interest in investing in stocks began while I was working in Boston. I worked with a lot of older people that were getting ready for retirement and listened as they talked about their investments. Taking a commuter rail to work each day, I developed a habit of being the last one off the train so that I could gather up discarded newspapers like the *Wall Street Journal*, *Investors Daily*, and occasionally, a *Barrons*.

Sometime in 1989, I tied into Prodigy, which is an on-line service for E-mail access and news updates. I soon discovered that I could track a list of stocks. Once I became comfortable with my knowledge of the market and after obtaining my wife's approval, I began to invest approximately ten percent of my income in stocks. I did most of my investing through the local Quick and Reilly office and was doing OK. Most of the stocks that I invested in were blue chip or well-known companies.

With the addition of our two sons, my wife and I decided that the country would be a far better place to raise a family. We knew what living in a small Maine community was like, the "Mayberry of Andy Griffith" life, and missed it dearly. So we moved to Maine, because that is the way life should be. In 1993, my son was diagnosed with dermatomyositis, a rare form of muscular dystrophy. I began to focus all my energy and resources into fighting and managing this terrible disease. By 1995, I could not keep a job because of all the medical attention my son required.

In 1997, we got on the Web to gain medical information about my son's illness and this got me more involved with stocks again on a day-to-day basis. I was buying and selling stocks more and sometimes on-line. I did this in an attempt to offset my son's medical expenses. I continued to use my discount broker, Quick and Reilly, which had been my broker from the beginning.

One day, while using Yahoo! Finance, I saw an advertisement for an Internet newsletter, "The Future Superstock," which was operated by an individual named Jeffrey Bruss. The site promoted a company called Electro-Optical, which developed and produced low-

<sup>1</sup>The prepared statement of Mr. O'Kane appears in the Appendix on page 73.

cost, high-quality fingerprint identification devices small enough to be placed on a computer mouse. "The Future Superstock" promoted Electro-Optical as its stock pick of the month, and a few weeks later as its stock pick of the year.

I was impressed with the engineering and low unit cost of Electro-Optical's technology and envisioned the product being used as a security device on everything from ATMs to door locks to computer mice. I invested approximately \$5,400 in Electro-Optical, purchasing 900 shares through my Quick and Reilly on-line account at slightly less than \$6 a share.

Based on the stock's performance, I felt it was behaving normally for market conditions. In January 1998, I spotted a press release about Electro-Optical on Yahoo! announcing a huge purchase order. After reading the press release, I became convinced that Electro-Optical and its product had tremendous growth potential. I immediately purchased 3,000 more shares at approximately \$6 per share. By this time, I had put in over \$23,000 in the company.

An article which ran in the *Bangor Daily News* in January 1998 entitled, "Computers to Send Fingerprints: New Technology Will Cut Identification Time for Maine Police," further validated my belief in Electro-Optical's product and the incredible possibilities it offered.

In February 1998, while surfing the Internet, I came across a Barrow Street Research press release that discussed Electro-Optical. In the fine print, Barrow Street disclosed that it had been paid to promote the Electro-Optical stock. I had never noticed such a disclaimer on any of the prior press releases or Web sites that I had used to make my investment decisions.

In March 1998, I had to take my son, James, to the New England Medical Center in Boston for treatment. Before returning to Maine, I decided that I should stop by Electro-Optical's office, which was located just outside of Boston. I was surprised when I was blocked from entering the building by the one employee that I saw. I looked into the building and was shocked to find that the building was completely empty. I expected to see an assembly line, equipment, employees, but there was nothing. I felt that Electro-Optical had completely misrepresented the nature of its apparently nonexistent operation. I immediately sold 1,900 of my shares for \$1.10 per share. Presently, my total loss is over \$20,000.

This experience reminds me of the old saying, if it is too good to be true, then it probably is. If one is looking to invest in a risky start-up stock, then he or she should go visit the company first. The other advice that I would offer is to acquire advice from a reputable stock advisor. Many bulletin boards on the Web are full of information from sources that are not looking out for your best interests. I listened to a newsletter that appeared to be professional to me because they had a Web site, published a letter on a regular basis, had Web links to the stocks that they recommended, had other firms' recommendations, which I never heard of, like Barrow Street Research, and appeared to know what they were talking about. Being an engineer, knowing a little bit about the technology, and feeling that Electro-Optical had a viable product with countless uses intrigued me.

This was my first attempt at investing in a stock promoted on the Internet and it will be my last. I have continued to invest online, but I now turn to an investment advisor for advice on all of my investments. The Internet provided my family with invaluable information regarding my son's condition, and today he is much better because of it. However, I also discovered the darker side of the Internet. Even after this experience, I still believe that the Internet does far more good than bad.

That concludes my oral testimony. Thank you again for allowing me to come here today to tell my story. Hopefully, it will help prevent others from falling into the same situation.

Senator COLLINS. Thank you very much, Mr. O'Kane.

Mrs. Morris.

#### **TESTIMONY OF KRISTIN MORRIS,<sup>1</sup> BERRYVILLE, VIRGINIA**

Mrs. MORRIS. Madam Chairman, Members of the Subcommittee, good afternoon to you all. I would like to thank you for allowing me the opportunity to share my experience with you this afternoon.

My name is Kristin Morris. I am a 34-year-old Washington, DC native. I have been married for almost 4 years and had my first child in October 1998. I am and have been an employee for 7 years with a small business, Advanced Computing Solutions, and we are resellers to the Federal Government, selling computer parts, components, and systems.

I have always felt that I am very knowledgeable about computers and the Internet. At the time of my original purchase of stock on the Internet, I felt very comfortable with the process. I first came upon Interactive Products and Services sometime in April 1997. At the time, I was losing money in the utility stock which I had owned for several years prior and thought I needed to get out of that investment and try to be a little bit less conservative with my money.

While surfing the Internet, I located a Web page through the "Webcrawler" search engine that maintained a list of different initial public offerings being offered over the Internet. I was attracted to IPS because of its products and its claims.

What enticed me were several main items. One, the products being offered by IPS made sense to me. These products were an Internet telephone and a hand-held keyboard/mouse that would work with Web TV and other like products.

I agreed with the owner of IPS, Mr. Bowin, and his suggestion that many people will purchase products like Web TV because of its cost. Computers are extremely expensive and are often more than the average person needs. Mr. Bowin went into this subject in detail. He discussed within the prospectus that many service-oriented and blue-collar workers would be more likely to purchase Internet television products before investing in costly computers because of the cost savings to them.

Third, Mr. Bowin included a link within his Web site containing an IPS press release announcing that they were in the process of working directly with companies such as Microsoft, Sun, Apple, and to integrate his IPS products to work with their software and their Internet TV hardware. These press releases stated that a deal was

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<sup>1</sup> The prepared statement of Mrs. Morris appears in the Appendix on page 76.

imminent and that he expected the stock to be worth somewhere around \$500 per share within the next 5 years. Of course, I saw this and I figured I could not go wrong. I thought I was getting in on the ground floor of something big.

Last, Mr. Bowin also included links within his Web site prospectus of camera-ready color photographs of the actual products themselves. These pictures were very impressive in their design. The prospectus gave detailed instructions on the products and how to use them. He even went on to claim in his description of the keyboard that the design was so innovative and so easy to use that it would change the way we type in the future.

Though the Web site looked very impressive, I did not rush immediately to buy the stock. Instead, I printed out the prospectus and had my husband read it over. We later agreed to sell my utility stock and invest \$1,000 in IPS. The minimum purchase of the stock was \$250. We knew, of course, we could lose this money if IPS did not succeed, but I never dreamed it was an elaborate scam and my money would be stolen.

Because the initial offering deadline was 2 weeks away when I first came across it, I only took two steps to verify the company. I called the long distance operator and asked for the telephone number of the address listed on the prospectus. I wanted to see if the number given to me by the operator matched the number in the IPS prospectus. This telephone number did match, so I then called the number and Mr. Bowin answered the call.

I asked several direct questions about IPS and its stock offerings. I asked Mr. Bowin how close he was to meeting his financial goals. He said he was close but he might need to file for an extension and told me this information was in the prospectus. I asked how the talks were going with Microsoft, Sun, AND Apple. He informed me things looked very good, but, of course, nothing was signed as of yet and anything could happen. Last, he said he had filed for a U.S. patent on the keyboard and the telephone product and this patent would be secured shortly. This information was also within the prospectus.

Satisfied with these answers, I proceeded to fill out the application form and wrote my check for \$1,000 payable to Interactive Products and Services. I sent the form and my check by certified mail. In a little over a week, I received my certified mail receipt with Mr. Bowin's signature. Actually, I remember feeling a little bit odd about that. Since my past experience working in the corporate world, I found it strange that someone so high up like a president or a CEO would personally sign for mail. But after my initial suspicion had passed, I decided it was no big deal.

A couple of months passed and the initial offering was over, but I still had not heard from IPS or received my stock certificates. I called the IPS offices and once again reached Mr. Bowin personally. I inquired as to when these certificates would be mailed. He informed me that the offering had been extended through July 1997. He told me to make a duplicate copy of my application and resend it. My stock purchase would be verified. I did as he requested.

After this last telephone conversation with Mr. Bowin, I would never again be able to reach him and no one from his office would return my messages. After several months, I gave up. I knew I had

been scammed. Out of sheer embarrassment, I never spoke of my experience to anyone. I wrote the money and experience off as a lesson learned the hard way.

Then, after many months had passed, I received a letter from the California State District Attorney informing me that Mr. Bowin had been arrested for fraud and I had been identified as one of his victims. I received another letter in December 1998 from the District Attorney stating that Mr. Bowin had been sentenced to 10 years in a California State prison and the case was concluded.

My advice to anyone looking to purchase the stock over the Internet is just do not. It is not worth the risk. An average investor like myself has no way to verify whether the stocks they are interested in are fraudulent or not. Until there is a solid, verifiable way to confirm the legitimacy of a stock, I just say, do not do it.

Today, I get an average of two E-mails a week offering stocks and "get rich quick" schemes. Many of these E-mails arrive without a return E-mail address, so even if I wanted to, I could not report them. These E-mails usually direct the recipient to a Web site announcing a stock purchase plan, and like the IPS Web site, many are extremely sophisticated and professional. I believe most of these stocks appeal to the small investor because they stress knocking out the stockbroker commissions and they play on past successes of Internet stocks. Anyone who even remotely follows the stock market knows the incredible gains these types of stocks have made in the recent past.

I consider Internet Web pages to be a much more sophisticated approach to fraud than the overzealous stockbroker who calls you at your home or your office. Whereas you can always hang up on the stockbroker, a Web page can be as professional and legitimate as any legitimate prospectus out there. These Web sites can even fool the most experienced of consumers.

I have no way to recover my money in which Mr. Bowin stole from me, but I would like to close by offering my opinion, better yet, my advice, which might help the average small investor like myself. I suggest that the SEC provide an authorized banner to any legitimate stock offering to post on their Web page. This banner could provide a central telephone number the consumer can call to verify an offering by either the stock name or by its registration number. One quick phone call to an SEC operator to check the name or the registration number and the consumer would immediately know if this was a legitimate security. I also believe this would inhibit any potential criminal activity, due to the fact that their stock would, of course, not be registered within the SEC. If I had been given this option, I know I would not be sitting in front of you today.

Again, thank you very much for allowing me to tell my story. I hope in some way your Subcommittee will find it useful. I appreciate what you are trying to do and I know it is a very difficult job you have ahead of you. Thank you.

Senator COLLINS. Thank you very much, Mrs. Morris.

I just want to get a few more of the facts of your two experiences before the Subcommittee.

Mr. O'Kane, how long had you been investing prior to stumbling upon the scam in which you lost your money?

Mr. O'KANE. I had been investing for about 10 years. I would consider myself a seasoned investor and I felt I understood the market at the time that I bought it.

Senator COLLINS. Mrs. Morris, how about you? How long had you been investing?

Mrs. MORRIS. About 5 years, mutual funds, IRAs, things like that.

Senator COLLINS. So neither of you were first-time, brand new at this. Each of you had considerable investment experience, which I think is an important point.

The other common thread that I noticed in listening to both of you tell your stories is that each of you were attracted to products that you thought you knew something about, and that is, of course, common investment advice that we are all given by the professional, is to invest in something that you understand.

Mr. O'Kane, how important was it to you that the engineering of the product that this company supposedly was producing made sense to you? Did that influence your decision, that being an engineer, you were able to bring your own expertise and it made sense to you?

Mr. O'KANE. It did affect the decision quite a bit. The write-up that they gave was, as far as the technology goes, realistic to me. I felt that they had a viable product because of my background, and yes, I think it did make a—carry a heavy part.

Senator COLLINS. And Mrs. Morris, I noticed in your case it was something related to computer products, and again, that is the industry that you are in.

Mrs. MORRIS. Right.

Senator COLLINS. Was that part of your comfort level, that it made sense to you?

Mrs. MORRIS. Yes, because when people come in—I sell to the Federal Government, but when Joe Public comes into our offices and wants to buy a computer, they nickel and dime you, and I knew that computers are very expensive and my first question to someone who walks in the door is, what do you want to do with it, and most of the time, they want to surf the Internet or they want to do E-mail, or they want to play games. This is why I thought the idea of having an Internet television product would suit the general public much more than a computer would and it is less expensive.

Senator COLLINS. And again, these appeared to be legitimate products based on your own personal expertise, and you each have a lot of expertise in this area.

Mrs. MORRIS. Yes.

Senator COLLINS. Mr. O'Kane, Mrs. Morris mentioned that she lost \$1,000. I understand that your loss was considerably greater. Can you tell us how much money you lost and give us some idea of was this a great deal of money to you, or put it in context for us.

Mr. O'KANE. It really was a great deal of money for me because it was part of my retirement and investment account I was using to generate income to live on. It was a considerable amount of my savings.

Senator COLLINS. How much did you lose?

Mr. O'KANE. It was—I try to forget—it was over \$20,000.

Senator COLLINS. So it was more than \$20,000. Have either of you received any restitution? I know in Mrs. Morris's case, at least you have the comfort of knowing that the person went to jail, and I believe, Mr. O'Kane, in your case, the SEC has some pending action. But to date, have either of you received any restitution? Mr. O'Kane, we will start with you.

Mr. O'KANE. No, I have not, not yet, but I have hope.

Senator COLLINS. Mrs. Morris.

Mrs. MORRIS. No. I will not receive—I received a letter from the District Attorney in the State of California stating that chances were very slim to none. But I do have the satisfaction that he is in jail, which most of the time is not the case.

Senator COLLINS. That is exactly right. One of the lessons that I took from your testimony is it appears that you put more trust in this scam in each of your cases because it came to you over the Internet. Mrs. Morris, could you expand on what it was about the professionalism of the scam that you uncovered, or the fact that you uncovered it yourself, this investment opportunity, that made it seem more credible to you?

Mrs. MORRIS. Well, I found it listed among many different IPOs that were being offered over the Internet. I chose that one because, like you said, it was in my field. I could understand it. It made sense to me. The prospectus itself was extremely sophisticated, down to the links and attaching itself to different Web sites, its own links with its own press releases. To me, it was not somebody calling me on the phone—buy this stock, buy now, buy now, buy now, where you do not believe a word they say. This was a very passive, where I took control, and I printed it out. I took my time. I made the phone calls and nobody was telling me what to do. So I had much higher hopes for it.

Senator COLLINS. So the fact that the Web page for the stock offering was a passive solicitation made it more credible to you?

Mrs. MORRIS. Yes.

Senator COLLINS. Because you found it as opposed to someone calling you at dinnertime?

Mrs. MORRIS. Exactly.

Senator COLLINS. What about you, Mr. O'Kane? Do you think if you had gotten a cold call at dinnertime with exactly the same information presented over the telephone that you would have invested?

Mr. O'KANE. I think I would hang up and finish my lunch.

Senator COLLINS. So the fact that these offerings were on the Internet gave them a credibility that they would not have had if you had received a call from an aggressive salesman at dinnertime, is that correct in both your cases?

Mr. O'KANE. That is correct.

Mrs. MORRIS. Correct.

Senator COLLINS. Mr. O'Kane, you said in your opening statement that when you first came across the information about Electro-Optical, that it was through an on-line newsletter called "The Future Superstock" and that you found this on Yahoo! and that the Yahoo! site then linked you to "The Future Superstock" Web site, which touted the fortunes of the company that you in-



vested in. Had you ever heard of this newsletter before or used it before?

Mr. O'KANE. Never

Senator COLLINS. And did you rely on this on-line newsletter which promoted this stock to make your decision to invest? Was it influential to you?

Mr. O'KANE. It was very influential. It appeared to be professional. It had all the appropriate links and it looked just like a blue chip-style company format.

Senator COLLINS. And at that time, were you aware that there is a problem with some of these on-line newsletters touting stocks that they are being paid to promote, or were you under the impression this was some sort of objective source of information?

Mr. O'KANE. No. I was not aware that they were paid for that.

Senator COLLINS. You subsequently learned that both "The Future Superstock" newsletter and the Barrow Street press release were, in fact, paid to promote this stock, is that correct?

Mr. O'KANE. Yes, it is.

Senator COLLINS. When did you first become suspicious?

Mr. O'KANE. It was after I already had my shares and I was looking at a press release from Barrow Street and the fine print on the very bottom said something to the effect that it was paid for by EOSC, and that is when I smelled a rat.

Senator COLLINS. So you saw the disclosure in this particular case. Would your decision to invest in Electro-Optical have been affected if you had known that the company paid this newsletter to promote its stock? Would you have still gone ahead?

Mr. O'KANE. It would most definitely make a difference, and whether I went ahead, I am not sure. I do not think so. I would have to seek the advice of somebody else. Someone is paying for that. No. I would not do it.

Senator COLLINS. Mrs. Morris, I was struck in your testimony that you did take some steps to try to verify the company rather than just immediately writing off your check for \$1,000. Now, as I understand it, for example, you knew to look through a prospectus and to request a prospectus, is that correct?

Mrs. MORRIS. Yes.

Senator COLLINS. And you also matched up the telephone numbers. Were there any other steps that you took?

Mrs. MORRIS. Well, I did call and I did speak with Mr. Bowin, who was the person who was president, CEO, the person offering the stock.

Senator COLLINS. And again, were you influenced by the press release you found on-line touting the stock?

Mrs. MORRIS. Yes, definitely. When I saw the names Microsoft, Sun, Oracle, or Apple, working closely, deals are imminent type of thing, and then him actually verbally saying these things to me also, yes, I was very satisfied.

Senator COLLINS. So in both cases, your decision to purchase the stock was greatly influenced by information in on-line newsletters, by press accounts that appeared to you to be legitimate, is that correct, Mr. O'Kane?

Mr. O'KANE. Yes.

Senator COLLINS. Mrs. Morris.

Mrs. MORRIS. That is correct, yes.

Senator COLLINS. And in both cases, it was the professionalism of the Web site, the links, the graphics, that it made it seem much more credible than if you had received just a solicitation by mail or the usual aggressive cold call at dinnertime, is that correct?

Mrs. MORRIS. That is correct.

Mr. O'KANE. That is right.

Senator COLLINS. Mrs. Morris, you said that your final advice, and I can certainly understand it, based on your experience, would be simply to not invest over the Internet. If, in fact, we were able to do the kinds of disclosures you talked about, having perhaps a third party verification of the Web site or other disclaimers put up front, would you feel more comfortable in making investments over the Internet?

Mrs. MORRIS. Yes.

Senator COLLINS. Is it really the lack of a way that you found to verify the information as opposed to the Internet itself?

Mrs. MORRIS. Yes. Right now, since there is no way to verify, they are not regulated. They can say whatever they want and there is nobody to tell the consumer, like myself, who comes upon their page, that it is not. Yes. The Internet is not a bad—it is a great place to find information about stocks. I can go out and I can research it, but I would not purchase it over the Internet right away. I would definitely take it to a reputable broker, someone who I would pay some money to direct me in the right direction. But no, I would not buy it over the Internet right now until there is a definite verifiable way.

Senator COLLINS. Mr. O'Kane, do you still invest on-line?

Mr. O'KANE. Oh, yes, I do.

Senator COLLINS. And you have had better experiences than the one before, I trust?

Mr. O'KANE. That is correct. I am using the widely-known stocks at this point.

Senator COLLINS. One of the purposes of these hearings are to educate consumers about what the resources are out there, and tomorrow, we are going to hear from both Federal and State regulators who have very good on-line tips for investing on-line that would be helpful to investors such as yourselves.

Senator LEVIN.

Senator LEVIN. Thank you, Madam Chairman.

When you say that you continue to buy stocks on-line, Mr. O'Kane, you do that, I take it, following your own advice that you now check out the stocks as reputable brokers or investing—

Mr. O'KANE. Yes, I do. I have an investment advisor that I check with.

Senator LEVIN. There was an article in the *Fortune* magazine that went into some of these stock scams and your experience was covered there and I am just wondering whether or not it was accurate when it said, for instance, that even after your experience and the visit to the company, you still felt there could be some value left in that stock. Is that accurate?

Mr. O'KANE. That is correct. I still have a few shares in the company.

Senator LEVIN. If you say that you should visit a company before you invest, you visited the company, but you still felt even after the visit that the stock might really be——

Mr. O'KANE. My stock is worth so little that it is like peanuts at this point and it made no sense to sell the whole thing.

Senator LEVIN. Was it immediately after your visit to the company that you decided to sell the stock?

Mr. O'KANE. Yes. I tried to get rid of it and I realized that my value was down to almost nothing at that point. I wanted to leave a little in so that I would still hear what the company is doing. It was a total loss, but we have some in there, so at least I get on the mailings.

Senator LEVIN. That article still says that you still surf the Web every day looking for hot stock tips, is that correct?

Mr. O'KANE. Oh, yes, I do that. I do, indeed.

Senator LEVIN. When you think you have got something that might be real, you then check that with your advisor, is that correct?

Mr. O'KANE. Right, and they usually tell me no. [Laughter.]

Senator LEVIN. I wish everybody who surfs the Internet for hot stock tips would check with an advisor and follow the "no" advice.

Mr. O'KANE. They should.

Senator LEVIN. It is not no advice, it is advice to not buy.

Mr. O'KANE. Right.

Senator LEVIN. I wish people would do that based on your experience, because I do not know how many people get burned every day by these kinds of hot stock tips. We checked one of these today, one of these hot stock tips, and I almost cannot believe that people can buy this stuff.

Here is one that came out Friday in one of these stock tip forms and it said, if you ever want a sure thing, and you push that one, and here it is. If you ever want a sure thing, it says here, buy GARM. The company was acquired by the largest recycling company in the world. This is a sure thing, by the way. The only thing is, nobody from that big company that bought it was allowed to buy so much as one share until after the shareholders meeting. In other words, this is inside information and no one else can buy that except you millions of folks reading this out there. It says here, the shareholders meeting is later on today. In other words, buy it quick, while you can, before this information becomes public.

When you take a look at what happened to that stock from Friday, when that tip was on the Web at 12:17, if you ever wanted a sure thing last Friday at 12:17—Bob is holding that up—do you see where that spike goes up in that second-to-last column there? That spike jumped up on Friday right after this hot stock tip. Well, someone got suckered into that. That last column is this morning, right back where it was. That spike represents a victim.

Mr. O'KANE. I defer that back to, if it is too good to be true, then do not do it.

Senator LEVIN. Yes. I was just learning how these kinds of scams were perpetrated today, and I was going through it and just picked one by random and that is one we picked. But somebody believed this tout, if you ever wanted a sure thing, you million people out there, a sure thing. A few folks, at least, thought that, somehow

or other, there was something for nothing, and bought it. Then this morning, that sure thing looked like it was dust and someone lost a lot of money between last Friday and this morning because they believed this kind of a come-on.

Hopefully, your testimony this morning and this afternoon and tomorrow's testimony will help other people resist these kind of temptations, because it is nothing more than just throwing dice on a table, and usually the dice are loaded against you.

Let me just ask Mrs. Morris a question, as well. You did get a telephone call?

Mrs. MORRIS. Yes, I did.

Senator LEVIN. So you were not just conned by the Web site being attractive and the information being put together professionally. You were skeptical and actually called the guy.

Mrs. MORRIS. Yes. I was conned by him personally.

Senator LEVIN. You were called by him?

Mrs. MORRIS. Conned by him personally.

Senator LEVIN. Oh, conned by him personally. So you were told that this stock was going to be going up, what, 500 percent in 5 years?

Mrs. MORRIS. Within the next 5 years after the initial product offering.

Senator LEVIN. Five hundred percent?

Mrs. MORRIS. Yes.

Senator LEVIN. Did that make you suspicious?

Mrs. MORRIS. Yes, because—I mean, I never expected it to jump. I knew, of course, that they over-hype it, but I did see that there could be some serious initial gains due to the product that they were offering, which I believed to be very viable. And the fact that they were dealing with Microsoft was a whole another issue. I just thought that alone, Microsoft—he touted the whole product as working with their software, Microsoft Home. Soon, his product will integrate with his software, Microsoft's software, be able to open your garage, turn off the lights, remote your TV, everything from that.

Senator LEVIN. I think both of your testimonies are important in terms of the credibility which some people apparently attribute to these stock touts on the Internet. They obviously do have credibility in the eyes of some people, and hopefully, people will be an awful lot more skeptical of these touts and these come-ons after your testimony than before.

There is only so much regulation we can do. We have talked to some of the regulators who say they get so many thousands of complaints of this, they cannot possibly catch up to them. For instance, in your testimony, Mrs. Morris, you indicated that we ought to have a quick phone call to an SEC operator to check the name or registration number and the consumer would immediately know. That is one way of doing it, but there is apparently a Web site that the SEC does have where you can check a stock registration number already.

Mrs. MORRIS. I did not know that.

Senator LEVIN. I think, and we are going to double check that to make sure I am not giving out bum information here. But I be-

lieve that that is accurate. If so, it would be useful along the lines——

Mrs. MORRIS. That would be very useful, but it would only be useful if someone knows to look for it.

Senator LEVIN. But somebody would have to know to call an SEC operator, as well.

Mrs. MORRIS. That is what I was saying. You should put it at—like IPS should have had that banner on their Web site, along with their offering.

Senator LEVIN. We could, for instance, perhaps figure out a way to require people to put down the Web site of the SEC——

Mrs. MORRIS. True.

Senator LEVIN [continuing]. On any stock tip.

Mrs. MORRIS. Sort of like a warning label on a pack of cigarettes. You have to have it there.

Senator LEVIN. Right. This stock is dangerous to your health.

Mrs. MORRIS. Exactly.

Senator LEVIN. Yes. Too many of them are.

In addition to the SEC, whether through a Web site or an 800 number or both, there is also this reputable stock broker or this financial advisor that people really should rely on more, and that is what your experience has taught you both, and again, thank you for coming forward. It will be, hopefully, helpful in having other people avoid your kind of losses and your kind of suffering, in the case of some of you. Thank you.

Senator COLLINS. Mrs. Morris, before I yield to Senator Edwards, I just want to ask you one final question, and that is, do you know how many other investors sent money to IPS?

Mrs. MORRIS. I believe 160 lost about \$190,000 all together.

Senator COLLINS. There was a substantial amount of money in the aggregate that was lost?

Mrs. MORRIS. Correct.

Senator COLLINS. Thank you. Senator Edwards.

#### **OPENING STATEMENT OF SENATOR EDWARDS**

Senator EDWARDS. Thank you, Madam Chairman. Good morning.

Mrs. MORRIS. Good morning.

Mr. O'KANE. Good morning.

Senator EDWARDS. Mrs. Morris, let me ask you this question. Did you, prior to your purchase, did you know what a direct public offering was?

Mrs. MORRIS. Yes, I did.

Senator EDWARDS. Maybe you mentioned this earlier, and I apologize I was not here——

Mrs. MORRIS. That is OK.

Senator EDWARDS. What kind of research did you do on Interactive Products and Services?

Mrs. MORRIS. When I first ran across the Internet site, I just basically read the prospectus. I called the long distance operator. The company was located in California. I called the long distance operator and used their address given on their prospectus as their corporate headquarters and verified that the number they gave me for them matched the number given on the prospectus. I then called the number and I reached Mr. Bowin, who was the president, I

guess, directly and spoke with him and asked him several questions about the offering, its products, and made my decision from that.

Senator EDWARDS. What kind of information would have been helpful to you in making a thoughtful decision about this investment?

Mrs. MORRIS. What I asked him, I thought was pretty thoughtful. I asked him, one, where he was in reaching his goal financially. I asked him about the products and his dealings with the other companies where his hardware would work with their software, the Microsoft, the Apple, the Sun, the Oracle, which he had stated. He also—we discussed a U.S. patent pending on his products, he said was basically coming down the line. It was imminent. Just several items like that.

Senator EDWARDS. Mr. O'Kane, let me ask you a couple of questions, if I can. Can you give me some idea of, from your perspective as an investor or potential investor, I gather that you had felt some comfort with using the Internet prior to making your investment, is that right?

Mr. O'KANE. Yes, I did.

Senator EDWARDS. Did you feel comfort in buying other kinds of goods over the Internet?

Mr. O'KANE. Yes, I did.

Senator EDWARDS. Tell me, knowing what you know now about the company that you invested in, or the lack thereof, can you tell me what kinds of disclaimers, information, would have been useful for you that would have alerted you to the potential problems you were confronted with?

Mr. O'KANE. Well, the number one thing I look for now is I scan down to the bottom of the newsletter or the press release or whatever and see if it is paid for by the stock that they are talking about. I check that first, look at the fine print.

Senator EDWARDS. What else? Is there anything else that you need to know?

Mr. O'KANE. Beyond that, I do not think there is anything they can offer me other than the SEC connections that I would go to now that I did not know about.

Senator EDWARDS. Thank you, Madam Chairman. Thank you both for being here.

Mrs. MORRIS. Thank you.

Senator EDWARDS. Your testimony is very important for what we are doing here today.

Mr. O'KANE. Good.

Senator COLLINS. I just have one final question for each of you. Were either of you aware that you could have called your State Division of Securities or Bureau of Securities for advice, to run this investment by them to see whether they had had any previous complaints, to see whether the investment opportunity was registered with the State? Were either of you aware of the State role in regulating securities? Mr. O'Kane.

Mr. O'KANE. No, I really was not.

Senator COLLINS. Mrs. Morris.

Mrs. MORRIS. No, not at all.

Senator COLLINS. Thank you. The States do do a good job—

Mrs. MORRIS. I know that now.

Mr. O'KANE. We know that now, yes.

Senator COLLINS [continuing]. In this area, but obviously, if investors who have been in the market as long as each of you have been, in one case 10 years and in one case 5 years, were unaware of the State role, that suggests we need to do a lot more to make people aware that help is out there. Thank you.

Mr. O'KANE. You need to have some of those banners posted on the sites.

Senator COLLINS. I think you are right. Thank you very much for sharing your experience and being here today. We have learned a lot from your experience. Thank you.

Mrs. MORRIS. Thank you.

Mr. O'KANE. Thank you.

Senator COLLINS. Our second panel will provide the Subcommittee with a broad overview of Internet securities fraud and describe Federal, State, and private sector efforts to combat this growing problem.

Our first witness is going to be Tom Gardner of The Motley Fool, which is a free on-line financial forum that is available over the Internet. The Motley Fool reaches millions of investors each month and provides financial information and investment strategies in several different mediums, including its Web site, books, radio programs, and newspaper columns.

Our second witness will be Howard Friedman, a professor of law at the University of Toledo. Professor Friedman has taught securities law for more than 30 years with a special focus on securities regulation and the Internet over the past several years. Last year, he published a book entitled *Securities Regulation in Cyberspace*.

Our final witness this afternoon will be Richard Hillman. He is the Associate Director with the Financial Institutions and Markets Issues Group of the U.S. General Accounting Office. He will summarize the findings of a GAO study that I initiated to determine the extent of Internet securities fraud and to discuss the efforts to detect these frauds by the Securities and Exchange Commission and State regulatory agencies.

Again, I welcome all of you and I would ask, pursuant to Rule 6, that you stand and raise your right hand so I can swear you in. Do you swear that the testimony you are about to give to the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. GARDNER. I do.

Mr. FRIEDMAN. I do.

Mr. HILLMAN. I do.

Senator COLLINS. Thank you. We very much appreciate your willingness to join us today. I would ask that you each limit your oral presentation to about 10 minutes and we will put your prepared testimony into the record.

Mr. Gardner, you may proceed. I want to tell you that I did go on site today on The Motley Fool Web site and had a great time. It was really very interesting.

Mr. GARDNER. Thank you.

Senator COLLINS. So please proceed.

**TESTIMONY OF TOM GARDNER,<sup>1</sup> HEAD FOOL, THE MOTLEY  
FOOL, ALEXANDRIA, VIRGINIA**

Mr. GARDNER. Thank you, Senator Collins. I would like to thank you, Senator Levin, Senator Edwards, and the other Members of the Subcommittee for holding these important hearings today and tomorrow.

My name is Tom Gardner and I am a co-founder of The Motley Fool, Incorporated, based in Alexandria, Virginia. It is a great honor for me to address the Senate Permanent Subcommittee on Investigations. After all, fools do not often get a chance to speak in the U.S. Senate.

Senator COLLINS. Some would disagree with you on that. [Laughter.]

Mr. GARDNER. I am pleased to have the opportunity to address the problem of securities fraud on the Internet today. I believe that the main factor that permits Internet securities fraud, indeed, all consumer fraud, is financial ignorance, and this sort of ignorance is exactly what we founded The Motley Fool to combat.

We founded The Motley Fool in 1994 to educate, amuse, and inform the individual investor. Starting with a little newsletter, we now have internationally syndicated newspaper columns, books, a syndicated radio program, and on-line areas, all meeting with popular demand because we believe, and many do, that individuals should take as much charge of their financial lives as they can.

The Motley Fool today recognizes that technology, especially the Internet, allows people across the world to do just that, by obtaining information that once was the exclusive property of the financial services industry. The general inaccessibility of critical information, coupled with the lack of financial education in America's schools, has delivered an ignorance that is the very reason we are meeting here today.

As this Subcommittee has previously learned, one of the worst examples of fraud that takes place on the Internet apparently involves micro-cap or penny stocks. Penny stocks are the shares of small companies that do not qualify for listing on any of our major exchanges but trade over the counter. These stocks generally trade at less than \$5 per share. Statisticians have noted that 75 percent of all the companies whose stocks trade for less than \$5 per share go bankrupt over any 10-year period.

These are the obscure diamond miners in Zaire. I have seen all of these come by, by the way. These are the obscure diamond miners in Zaire, the meat packing business that just launched an Internet service, the fingerprint technology company at 10 cents per share that claims it will provide the foundation for all transactions in the century ahead, all ludicrous, but many of them gathered a following.

Now, because these companies do not trade on the major exchanges, they often do not need to make comprehensive electronic or hard copy filings with the SEC. Further, because of their relative obscurity, many of these public corporations lack liquidity. In many instances, the majority of the shares in a penny stock company are held by company insiders and/or promoters.

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<sup>1</sup>The prepared statement of Mr. Gardner appears in the Appendix on page 79.



But why, when they present such little opportunity to long-term investors, do penny stocks still attract attention? Inexperienced investors are certainly attracted by the fact that they can buy a ton of shares with very little money. To take an extreme example, \$3,000 could buy you only one share of Warren Buffett's Berkshire Hathaway Class B stock today, but it could buy you 6,000 exciting shares of, say, Marginal Technology Systems, Incorporated, at \$.50 per share.

The combination of the opportunity to hold large share positions and that appearance of unlimited upside draws scads of new investors into this most highly speculative form of equities ownership. After all, if the micro-cap stock goes up just \$.50, the stockholder would double his or her money. on-line con artists take advantage of this gambling mentality of untrained investors today. Indeed, penny stocks are the public market's own brand of lottery ticket, the engine of financial dissolution among those who have not been educated about their money.

For this and numerous other reasons, The Motley Fool abhors the dreaded penny stock. Penny stock ownership is not beneficial for newcomers to our public markets. It is generally absurdly comic to experienced investors and, thus, is not reported on or covered at The Motley Fool on-line.

The question remains, though, what can we do about this? Our company's answer is education. If people knew enough not to make investment decisions based upon tips, rumors, and touts but to do their own homework, they would not fall for most stock frauds. The SEC has played an active role in trying to educate investors. In truth, though, they have a gigantic task ahead of them. They face massive financial illiteracy in this country, though not nearly so substantial as that across the world, because a great number of Americans are never taught the basic principles of personal finance and investing in school or at home. If we as a country are concerned about citizens' ability to control their own financial futures, to avoid fraudulent offerings, to sidestep poor investment vehicles, and to rely less on Government in the decades to come, then this ignorance is collectively our greatest obstacle.

At The Motley Fool, we coach a few common sense principles to help individuals make sense of the money world. We advise that they do their own homework, understand what they own, not act on tips, and not instinctually believe the conventional wisdom that professionals in the financial services industries always know what they are doing and always have their clients' best interests at heart. If something sounds too good to be true, it probably is. If someone implies that you must act now to win big, skip it.

It is clear to us that the only sure fire way to get rich is to be patient, to learn more about investments, to understand the role of money in the world, and to know thyself. Though unoriginal, these are principles that have served us and our community well.

Thank you again for inviting me to be here today and I will be happy to answer any questions you have later.

Senator COLLINS. Thank you very much. Professor Friedman.

**TESTIMONY OF HOWARD M. FRIEDMAN,<sup>1</sup> PROFESSOR OF LAW,  
THE UNIVERSITY OF TOLEDO, TOLEDO, OHIO**

Mr. FRIEDMAN. Thank you, Madam Chair, Members of the Subcommittee. I am Howard M. Friedman, Professor of Law at the University of Toledo. My book, "Securities Regulation in Cyberspace," and my recent research focus on the impact of Internet technology on securities regulation. I appreciate the opportunity to testify before you today. My written statement explores additional issues beyond those which I am able to cover in my 10-minute oral statement.

The Internet revolution is an information revolution. The securities markets are natural early adaptors of new technologies that make information more accessible. The Internet is young. Important experimentation to find its most effective uses is still underway.

Despite occasional problems of system capacity, a major success story of the Internet is on-line trading. An outgrowth of on-line trading and low commission rates, however, is the troubling explosion of day trading which creates excessive volatility in the price of shares.

For at least a significant number of day traders, their activities more closely resemble on-line gambling than on-line investing. Many of the dangers of gambling, including the addictive element, are present in unrestrained day trading. Therefore, it is important for brokerage firms to have in place appropriate criteria to screen investors who are permitted to engage in day trading on-line.

Currently, when a brokerage firm makes an investment recommendation to a customer, the recommendation must be suitable in light of the customer's investment objectives and financial circumstances. However, now clients increasingly trade on the basis of their own research. A critical regulatory question is whether the suitability obligations now imposed on broker-dealers should be expanded in an on-line environment.

Should broker-dealers be required to monitor the on-line trading of their clients? Should they not be required to intervene when clients use trading strategies that are vastly out of line with their investment goals and financial situations, even though the trading has been undertaken without any recommendations from the brokerage firm? Imposing responsibility on brokers seems appropriate, since it is the brokerage firm's trading facilities that permit the customer to engage in inappropriate trading strategies.

Since the Internet revolution, information previously available only to investment professionals now is available to everyone at the click of a mouse. However, excessive data can result in information overload. Many investors, understanding this, welcome the newly available information but continue to rely on investment professionals to assist them in interpreting it. However, others do not. They, instead, use the Internet to seek out investment recommendations and stock tips. They rely on postings from often unknown sources who seem to have filtered through the mass of available information. In this way, they may become victims of securities fraud.

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<sup>1</sup>The prepared statement of Mr. Friedman appears in the Appendix on page 92.

A famous cartoon in the *New Yorker* portrayed two dogs sitting in front of a computer screen with one saying to the other, "On the Internet, nobody knows you are a dog." Well, similarly on the Internet, Web sites that are "dogs" can easily look as professional as those of the most established firms. Moreover, at least in its early years, the Internet fostered a culture of community and trust that further encourages indiscriminating reliance by investors on all sorts of on-line investment recommendations.

The various sorts of Internet securities fraud have a single common thread. In each case, the victim relies on exaggerated recommendations or false information transmitted on-line by a person who will profit from the victim's reliance on the information. The profit may come from secret payments by others to the person promoting the stock or may be realized when the stock price rises and shares secretly held by the person engaging in the promotion are dumped on the market.

Many so-called Internet stock frauds are traditional garden-variety scams which have merely migrated to the Internet. Other frauds, while resembling traditional ones, have taken advantage of the special capabilities of cyberspace. While much information on the Internet is accurate, the Internet is also an effective instrument for disseminating false investment information because it permits simultaneous transmission of information to thousands of investors around the world; it permits and even encourages information to be transmitted anonymously; and it discourages qualitative differentiation between different on-line sources of information.

Bulk E-mailing, called spamming, permits promoters to reach thousands of persons at an extremely low cost. For less than \$300, software is available that will harvest thousands of E-mail addresses from Internet files and create mailing lists from them. Similarly, bulk E-mail address lists can be purchased. One Web site offers a list of 10 million names for \$10,000.

Perhaps the most common on-line frauds are "pump and dump" schemes. Using Web sites, on-line newsletters, or Internet bulletin boards, insiders, brokers, or large shareholders drive up the price of the stock through posting false rumors on-line. Often, these rumors are posted anonymously or under assumed names. Once the market price is impacted by these rumors, the fraudsters sell off their earlier acquired shares at inflated prices. Then when the rumors prove to be untrue, the stock price declines for everyone else.

Existing laws seem sufficient for prosecution of most Internet securities fraud. In some ways, Internet securities fraud is easier to detect and to prove than fraud carried out through high-pressure telephone sales. E-mail leaves a trail on disks. Enforcers can often discover fraudulent representations on Internet bulletin boards and Web sites by surfing the Internet searching for words associated with fraudulent offers. on-line complaint centers make it easier than ever for investors to alert enforcers to problems.

The international reach of the Internet, however, does create enforcement hurdles and continued strengthening of international enforcement cooperation will remain critical.

While prosecution is important, prevention is even more critical. In examining what additional preventive efforts are needed, we

must remember that risk inheres in our securities markets. Innovation requires risk. Our securities laws, however, are designed to assure that investors understand the risks they are assuming.

To summarize, I would suggest three approaches that may help prevent future victimization of investors. First, securities professionals, broker-dealers and investment advisors, are gate keepers at the entrance to the securities markets. They should have heightened duties to screen out on-line investors who are pursuing investment strategies that are clearly too risky for their financial situations and investment goals.

Second, inexpensive software can make a fly-by-night financial Web site indistinguishable from those of well-established firms. Some type of third-party verification is needed to vouch for the legitimacy of particular sites. An accounting industry program for commercial Web sites issues a special seal to home pages that have passed an audit. A similar program might be instituted for financial Web sites. When we move from Web sites to E-mail and bulletin board postings, anonymous messages may be a source of fraud. Securities regulators and industry groups should encourage the use of digital signature technology to permit accurate identification of those posting financial information.

Finally, we need to ask why investors are willing to believe on-line promises of quick wealth and on-line rumors posted by unknown informants. Publicity campaigns have alerted consumers to all sorts of physical health risks. Similar techniques should be used to alert investors to risks to their financial health posed by unsafe investment practices. A start has been made in this direction with programs designed to increase personal finance instruction in American high schools. Educational materials are widely available on-line, including through the SEC's Web site. However, more significant investments in educational campaigns through the media will be required for the message to be disseminated effectively.

Thank you.

Senator COLLINS. Thank you very much, Professor. Mr. Hillman.

**TESTIMONY OF RICHARD J. HILLMAN,<sup>1</sup> ASSOCIATE DIRECTOR,  
FINANCIAL INSTITUTIONS AND MARKETS ISSUES, GENERAL  
GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OF-  
FICE, WASHINGTON, DC**

Mr. HILLMAN. Thank you, Chairman Collins and Members of the Subcommittee. I am pleased to be here this afternoon to discuss Internet securities fraud and the challenges it poses to regulators and investors.

The Internet is providing the basis for a rapid transformation of the securities industry. As the Chairman said, in her opening remarks, although there are several benefits that the Internet provides to investors, such as immediate access to price quotes on stocks or mutual funds and readily accessible stock market research data, the Internet also provides a new medium for fraudulent operators to bilk investors out of millions of dollars. Attractive features of the Internet to fraudulent operators include the ability to anonymously communicate with millions of potential victims at

<sup>1</sup>The prepared statement of Mr. Hillman appears in the Appendix on page 102.

far lower costs than traditional means and the ability to do so quickly from virtually any location in the world.

This afternoon, I would like to briefly touch on the three areas you requested information on in your letter announcing this hearing. These are, first, the incident rate and types of Internet securities fraud violations that the SEC and others have identified; second, a discussion of the steps that SEC and State securities regulators have initiated to combat Internet fraud; and third, a description of the enforcement actions taken to deter fraudulent conduct. I would like to close my oral remarks with a discussion of some of the challenges that regulators face in combatting this problem.

Currently, there are no comprehensive statistics available on the incidents or types of securities frauds committed over the Internet. However, State, SEC, and other Federal agency officials we have contacted said that the Internet securities fraud is an emerging problem which is likely to grow as the use of the Internet continues to expand worldwide. One rough indicator of the growth of Internet securities fraud is the number of public E-mail complaints that are submitted to SEC's Internet Web site. According to SEC officials, the number of such E-mail complaints, many of which allege the potential Internet securities frauds, soared from about 10 to 15 daily in 1996 to between 200 and 300 daily in early 1999.

The types of securities frauds reported to be occurring over the Internet are generally not new. The Internet seems to be providing a new medium to perpetrate traditional investor frauds, such as stock price manipulation schemes. However, some securities frauds appear to be unique to the Internet environment, such as the illegal copying of broker-dealer Web pages.

One illustrative incident occurred in California in May 1997. A broker-dealer in California reported that its Web site had been copied and the company name, address, and telephone numbers slightly altered. The perpetrator used the new but bogus Web site to dupe foreign investors into sending funds to addresses listed on the new Web site. This scam went on for about 10 months, until perpetrators moved on and copied another company's Web site to repeat the same scam.

Another frequent scheme involves perpetrators touting false information on small companies through Internet spam, Web sites, on-line newsletters, or other means in order to increase investors' purchases of securities, thereby raising share prices. The fraudulent operators already own large numbers of these securities and are able to make quick profits by selling the securities as prices increase, while others face significant losses when artificially inflated share prices drop.

The sale of unregistered securities on the Internet is another type of fraud being reported among the States we visited. In addition, other State securities regulators have reported the illegal sale of securities over the Internet involving offshore gambling enterprises, time travel technology, Hollywood movie theme restaurants, and air conditioning and helicopter production companies.

Financial losses suffered amongst victims of fraudulent schemes on the Internet have ranged from \$18,000 to over \$100 million.

SEC has responded to the growing Internet fraud problem by, among other things, creating the Office of Internet Enforcement to coordinate the agency's efforts to combat Internet fraud, providing training to SEC investigative staff on monitoring the Internet, and preparing guidance for SEC staff who are investigating potential Internet frauds. The Internet Office has three full-time staff and about 125 volunteer staff in SEC headquarters and regional offices who work on a part-time basis to identify Internet fraud-related activities.

In addition, SEC has established programs to educate investors about the risks associated with Internet securities frauds. SEC has posted investor education information on its Web site, sponsored town meetings, and produced pamphlets on the risks associated with Internet securities investments. Their primary message to individual investors is that given the potential for fraud, investment decisions should not be based solely on information obtained over the Internet.

Rather, investors should perform a number of independent steps to ensure the accuracy of Internet information. These steps include reviewing financial information about a company that may not be available off the Internet; determining whether a company is, in fact, developing a technology as advertised and contacting companies that are alleged to be in the process of signing contracts with the company in question. Unless investors are willing to take such steps, the SEC suggests that investors may want to avoid using the Internet as a basis for making investment decisions.

At the State level, nearly half of the State securities agencies we surveyed had developed programs to deter securities fraud on the Internet. These programs generally consisted of monitoring the Internet for fraud, which varied widely from about a half-hour daily to one time per month. We note that the North American Security Administrators Association contributes significantly in this area. The organization provides investor education and serves as a clearinghouse for investor complaints.

Regarding enforcement actions, SEC has initiated 66 enforcement actions since 1995 against individuals and companies for securities fraud. As of February 1999, 32 of the 66 cases had largely been concluded, with violators generally required to pay civil monetary penalties or refrain from further violations of the securities laws. The civil monetary penalties that SEC imposed range from \$5,000 to \$4.4 million. In two of these cases, Federal and State law enforcement agencies also obtained criminal convictions or prison sentences for seven individuals.

According to SEC officials we contacted, the agency has limited staff and other investigative resources and it is not able to pursue every credible allegation of securities law violations, including Internet frauds. Thus, SEC officials said that the agency investigations often focus on what they call message cases that have a high degree of public notoriety. According to SEC officials, message cases are intended to punish wrongdoers for egregious offenses and send a broader message to deter would-be violators.

Collectively, State regulatory agencies have initiated about 190 enforcement actions against persons and companies accused of violating State securities laws. Nearly all of these enforcement actions

resulted in warning letters, informal agreements, or the issuance of cease and desist orders.

State criminal enforcement agencies have pursued criminal cases, as well. However, State and regulatory agency officials report that State enforcement actions are not effective across other States. That is because an enforcement action brought by one State may deter persons or companies from committing fraudulent acts in that State, but it does not necessarily prevent persons or companies from committing the same scam through the Internet in other States.

Although SEC and State agencies have initiated programs to combat Internet securities fraud, these programs are new and it is too early to predict their long-term effectiveness. On the basis of our work, however, we have identified several potential challenges that could limit the ability of these programs to protect investors from Internet scams. In particular, the potential exists that the rapid growth in reporting Internet securities frauds could ultimately place a significant burden on the regulators' limited investigative staff resources and thereby limit the agency's ability to respond effectively to credible fraud allegations.

Another ongoing challenge is coordinating oversight amongst international, Federal, and State securities regulators so that fraudulent operators are deterred from taking advantage of the fact that Internet frauds can be initiated from virtually anywhere in the world.

A final challenge involves reaching a broad audience to educate the investing public about the risks associated with Internet securities frauds. Since regulatory resources are limited, preventing investors from falling into Internet securities frauds in the first place may be our best way to contain this problem.

Madam Chairman, I commend you for holding this hearing and thank you for inviting our observations on Internet securities fraud and regulatory efforts to combat this growing problem. Hearings such as this are particularly useful because they provide a public forum for educating large numbers of investors that while the Internet has much to offer, there are also potential risks, as well. We look forward to working with you and your staffs in this important area.

Senator COLLINS. Thank you very much, Mr. Hillman.

Mr. Gardner, knowing of the dangers of penny stocks, I want to commend you for the efforts that you have taken at The Motley Fool to monitor your chat rooms and your bulletin boards to make them inhospitable to penny stocks. I would note that the actions that you take are unusual, that the Subcommittee has done some investigation in this area and most of the major on-line financial forums, such as Yahoo! or Silicon Investor, do not police their chat rooms or their bulletin boards, or at least not in an aggressive way. That raises the question in my mind of what responsibility do on-line financial forums have to aggressively monitor and police their bulletin boards and chat rooms.

Mr. GARDNER. I am not really sure what responsibility they have, because I believe that in a free market system, over time, individuals and consumers will come to recognize where the value resides in different pockets. The earlier that we can identify that and the

earlier that we can get the message out that monitored chat rooms and message boards are a great benefit because they set a context, they give people an understanding of what kind of community they are coming into. It is my great wish that all financial sites had monitors. It is an expense that we have to shoulder, but it is an expense that is worth it because, again, it sets the tone for the entire community. But I am not sure about placing regulations or responsibilities on sites automatically to do a certain amount of monitoring of their pages.

Senator COLLINS. Professor Friedman and Mr. Hillman, what do you think of this idea? How much responsibility do you think that on-line financial forums have to monitor or police their bulletin boards and chat rooms? No one wants to interfere with the flow of free information on the Internet. No one wants to impose vast new Federal regulation on the Internet. And yet, we clearly have a problem here, as we have heard from our previous witnesses. Is self-policing the answer? Are steps such as The Motley Fool has taken the answer, Professor?

Mr. FRIEDMAN. Well, there is always the danger of too much censorship when you put liability on bulletin boards and other providers. I should add that there is a provision in the 1996 Communications Decency Act which, while it was directed at defamation and obscenity and not at fraud, probably shields bulletin boards from a good deal of liability, at least in civil actions, in this area.

Senator COLLINS. Mr. Hillman.

Mr. HILLMAN. I believe some form of monitoring or policing of chat rooms would be something worth looking into. Such practices already take place in certain broker-dealer firms, where you have the broker-dealers' disciplinary records showing a history of unscrupulous actions. There are audio tapes of calls that are being made by these brokers and some similar form of oversight in the Internet industry would be worth looking into.

Senator COLLINS. Mr. Gardner, it is my understanding that The Motley Fool created a fictitious stock and then hyped it to show how easily investors can be sucked into the hype and to make investment decisions. You mentioned it in your written testimony, but because of time constraints did not in your oral presentation. Could you tell us a bit about that and what lessons you think can be gained from that experience?

Mr. GARDNER. Certainly. When we started on-line in the early 1990's, we walked into an environment where there was a lot of loud promotion of what we consider to be very low-grade investment opportunities, again, unlisted stocks in the United States, over-the-counter stocks, or Vancouver Stock Exchange securities. Unfortunately, Vancouver is a lovely city, but their stock exchange stands out in my mind as a haven of very low-grade businesses, or a number of them.

We tried, as best we could, as earnestly as we could, to teach people about the very spike that we saw on the graph earlier presented, and that there were small brokerage firms and individuals and companies participating in the promotion of their stock in an attempt to get a 30-cent share stock up to \$2 over the next 2 weeks, and then they would turn and move to a new company. As



outrageous as some of the claims of the companies were, there were enough inexperienced investors that these were successful scams.

What we tried to do in teaching people was totally overrun by, again, a very creative and very critical move against education on-line at the time. So what we did was we created our own penny stock, our own foreign exchange, the Halifax Canadian Exchange—

Senator COLLINS. Which does not exist, correct?

Mr. GARDNER. Which does not exist. We created this whole scenario on April 1, 1994, and walked through it over about a 6-day period, and during that period, we probably got 1,000 E-mails, a number of them from people saying, I cannot buy the stock. Where is this exchange? I have asked my broker to locate it. Then about 6 days later, we collapsed the entire story of Zeigletics, and we did so to really show step by step what happens when a thinly-traded micro-cap stock is promoted.

I think Senator Levin has correctly found one, and I also agree that there are hundreds of examples, if not thousands of examples, of this over the last 5 years. And if there is one corner of the overall market to pinpoint to shed more light on for greater clarity to guide individual investors on, it is those companies that have the capitalization under \$50 million that are not listed on our exchanges for which there is not a lot of public information.

But we created that April fool's joke. We believe that is our national holiday at The Motley Fool, and we did so to really educate people about why these investment options really are options to be avoided.

Senator COLLINS. And Zeigletics sold what? What was the product?

Mr. GARDNER. Zeigletics was selling linked sewage disposal systems around the world, and one can infer what we thought of their product based on that description.

Senator COLLINS. With a concentration in Chad, as I understand it.

Mr. GARDNER. Exactly, and that is actually a critical component of so many of these scams, is that they are a business that is happening internationally that one could not verify. You could not travel down to the company headquarters very easily because they were doing business abroad. They were located abroad. They were listed on a foreign exchange. That kind of far-away nature and that remote, obscure business is something that I think untrained investors who have a belief that the way to make money off their savings is to gamble, and that has been reinforced in a number of places in our society, then think that they need inside information and a secret sauce investment approach to do well, and, therefore, those are the most attractive first options to them, unfortunately.

Senator COLLINS. The language you used also was very typical of what you see with the hyping of these penny stocks, saying that if you have not bought the stock yet, you are no player at all, a lot of times implying that someone is going to miss out on this exciting opportunity to, as our previous witness said, to get in on the ground floor. It is stunning to me that, given what you portrayed, that you had over 1,000 E-mails from people who were unhappy

they could not find this fictitious stock. I think that suggests we have a long ways to go on consumer education in this area.

Mr. GARDNER. We certainly do.

Senator COLLINS. Mr. Hillman, Professor Friedman and Mrs. Morris made a suggestion that there be some sort of third-party verification to give, say, a seal of approval to a Web site that it is legitimate, and the professor mentioned a program that I believe it is the American Association of Certified Public Accountants has that has that seal of verification.

How practical do you think that is, given the vast number of stock offerings that we are dealing with and Web sites? I mean, it is millions and millions of Web sites out there now.

Mr. HILLMAN. And there are hundreds more being developed every day. I think that one of the better ways of perhaps tackling this problem is through investor education, tapping investors' knowledge at the source so that they do not fall for these types of frauds to begin with.

Senator COLLINS. Professor Friedman, another one of your suggestions was extending the suitability requirements to on-line trades that would otherwise apply in a normal relationship that an investor would have with his broker. Could you expand more on your proposal in that regard?

Mr. FRIEDMAN. Yes. Right now, the suitability requirements, the requirements that brokers limit sales to securities that are suitable for an investor's financial situation, apply where brokers are making recommendations. But in today's on-line environment, very often, brokers are not making recommendations at all. People are doing their own research, sometimes from the broker's Web site, sometimes from elsewhere. But, nevertheless, a monitoring of the customer's activity would show the broker that this customer is trading in ways that are very unsuitable, and expanding brokers' obligations to that, I think, might well cut off some fraud, or at least some losses, that investors are now suffering.

Senator COLLINS. Thank you. Mr. Gardner, many of us are concerned, as I know that Professor Friedman is and you mentioned in your written testimony, about the growth of day trading. Do you think that the explosive growth of day trading presents the opportunity for more of the kinds of market manipulations, particularly "pump and dump" schemes, that we are seeing?

Mr. GARDNER. Certainly. I think any time you have a number of investors focusing on the short-term performance of stock prices rather than the intermediate or long-term success of a business, you are going to have opportunities and attempts at trying to manipulate the movement of those prices in the short term.

The simplest solution came out of Omaha, Nebraska, a number of years ago when Warren Buffett said, let us just create—it should make the government happy, as well. Let us create the 100 percent short-term capital gains tax. That is, if you trade out of your position within a year, you pay your entire profits to the government, and that will encourage people to look at the public markets as the mechanism that they were created for, ownership of public companies and financing for those businesses.

But short of that, increased education, and I do not think this is a sustainable problem because the economics of day trading are

so unattractive and the lifestyle of the day trader is also so unattractive that I think, over time, we are going to see this gleaned out.

Senator COLLINS. Thank you. My time for this round has expired.

Senator LEVIN.

Senator LEVIN. Thank you, Madam Chairman.

I want to get back to the question of responsibility, suitability obligation of brokers. I take it that the day trading firms also have that responsibility now, but your point is that that responsibility is limited now to the occasions where they are recommending the specific purchase of a stock and does not go to the strategy which a customer might use to engage in day trading. Is that generally correct?

Mr. FRIEDMAN. That is right.

Senator LEVIN. All right. So is the suitability obligation that we place on brokers done by law, by regulation, by self-regulation? Where does that suitability obligation emanate?

Mr. FRIEDMAN. It comes primarily from the rules of the NASD and the New York Stock Exchange, although courts have also read it into common law fiduciary duties. But the most direct obligation is from the NASD and New York Stock Exchange Rules.

Senator LEVIN. So we have not through SEC regulations or through legislation been the source of that obligation?

Mr. FRIEDMAN. There is a limited SEC suitability obligation in the penny stock area, but beyond that, it is in the self-regulatory organization rules, although those are all rules that the SEC has to approve. The SEC oversees those rules and coordinates its own regulation with those of the NASD and the stock exchanges.

Senator LEVIN. But this is the penny stock area, basically, that we are most concerned about, is it not, so-called penny stock?

Mr. FRIEDMAN. Some of it is. Some of the trading, some of the day trading goes beyond things that are within the definition of penny stocks, however.

Senator LEVIN. We can take this issue up tomorrow with our witnesses, but let me ask a few questions of our witnesses today. Do either of you, Mr. Gardner first, Mr. Hillman second, have any reaction or comment to the suggestion that the suitability obligation be extended, in effect, to a customer's investment strategy, where they are engaged in day trading, to make sure that that strategy is suitable to that customer's investment goals and financial circumstances? Do you have any reaction to that?

Mr. GARDNER. I have some reservations about applying guidelines that brokers have to follow or discount brokers have to follow. I believe the recommendations and strong recommendations and the opportunity for those discount brokers to promote that they are following those recommendations and use it in their promotional material, it is a great idea.

Basically, when it comes down to the sort of speculative side of the public markets, I think the single best combatant to that is education because there is simply, numerically, there is no support of trading that way for your long-term benefit.

Senator LEVIN. Maybe not for each individual's long-term benefit, but there are more new individuals coming along all the time.

Mr. GARDNER. That is true, and unfortunately, day trading also benefits a lot of brokerage firms. It was not started on the Internet. We all know that. Right now, the commission-driven compensation at the firms does reward that sort of active trading. But again, I am a strongest advocate of making sure that the new investor that comes in has set materials and reads through stuff and then has an understanding what they are doing.

Senator LEVIN. Thank you. Mr. Hillman, do you have any reaction to the proposal of Professor Friedman?

Mr. HILLMAN. We have not looked into the day trading phenomenon itself. We have been pretty much focused on Internet securities fraud. However, day trading activity is something that deserves some additional attention. I have concerns about whether day traders who trade stock through these niche brokerage firms actually are aware of the risks associated with this trading activity and would therefore recommend that more could be accomplished in the disclosure area to determine whether or not day traders are being made aware of their risks.

Senator LEVIN. Should anybody who uses electronic means to buy stock be required to be a recipient of the message as to what the SEC Web site address is? In other words, one of our earlier witnesses said she was not aware that there was a Web site of the SEC where stocks are registered. She could have checked it out. Should any electronic dissemination of a stock tout or suggestion that somebody buy stock be required to be accompanied by the Web site address of the SEC? That is my question. I guess, let me start with Mr. Hillman.

Mr. HILLMAN. I think that is an interesting idea and something that probably ought to be looked into.

Senator LEVIN. OK.

Mr. FRIEDMAN. I think that many of these are offerings that are made under an SEC exemption from registration, so it really would not do all that much good. Many of these are sold under Rule 504 as offerings of under \$1 million. Where it is a registered offering by the company, present law requires that the prospectus itself be delivered either electronically or in paper form before the person purchase? So when we are talking about the company itself offering securities, many of these offerings are made, or at least supposedly made, under exemptions.

Senator LEVIN. OK.

Mr. GARDNER. I am in support of any materials that are released that give people more information about the shadowy parts of our public markets, which I think are activities off the major exchanges. We require so much of our public companies in terms of their disclosure, if they are to be listed on the NASDAQ, the NYSE, or the AMEX, and I think a lot of those disclosure requirements should extend to any company that is selling stock to investors.

Senator LEVIN. Let me ask each of you about the practice of day trading firms aggressively recruiting inexperienced people that take courses and become day traders. We have seen examples. They are very expensive, some of these courses, too. It could be many hundreds of dollars to take a course as to how to become a gambler, or a day trader. I am just wondering if you think there is anything that can or should be done about those aggressive mar-

keting tactics to try to train you to—and the more inexperienced, the better, by the way, some of these ads run. The less you know about the firms, the better off you are in terms of becoming a day trader. It is ultimately touted that way.

But at any rate, any suggestions from any of you as to whether there ought to be any control, regulation over those kinds of aggressive recruiting practices? Mr. Hillman.

Mr. HILLMAN. Again, I think disclosure is something worth looking into. For example, to what extent have these firms disclosed to these new day trading investors the number of day traders that have made money and the number that have lost money? If they provided information over a 3-month period of time of the number of investors who had lost money during such activities, perhaps that would give them some information to think about.

Senator LEVIN. Are you contemplating such a requirement by Federal regulation?

Mr. HILLMAN. The General Accounting Office has done no work in the day trading area. I am speaking from personal knowledge and considering best practices.

Senator LEVIN. I would be particularly interested as to whether or not any of you think that there is a role for Federal regulation or Federal law in this or any other area, for that matter. Professor Friedman.

Mr. FRIEDMAN. I think that kind of disclosure obligation under Federal law might make sense. I think probably some of those ads already violate anti-fraud provisions, depending on what they say. I think, unfortunately, this attraction of day trading is part of a broader notion in our society. People think that if they invest in good, old-fashioned, safe, low-return kinds of investments, that somehow they are fools for doing it, excuse the pun.

Mr. GARDNER. With a small “f”. It was a small “f”, Mr. Friedman, I am sure. [Laughter.]

Senator LEVIN. That was a commercial, as a matter of fact.

Mr. FRIEDMAN. It is.

Mr. GARDNER. Spell the name right. That is all that counts.

Mr. FRIEDMAN. Day trading is just another example of the prevalent idea that “I have to get rich quick.”

Mr. GARDNER. I think to the extent that we can start by applying the existing guidelines for advertising, that we could probably clean up a lot of the stuff that is going on out there today. I do know that one individual, who, for legal purposes I will not put his name in the record, but I believe that his radio advertisement was suggesting that individuals using his stock option strategy could expect 20 to 40 percent growth per month.

So what do we do at our on-line site? Rather than read through all the materials and figure it out, we simply took \$1,000 and said, if it grew at 20 percent a month, how much would you have after 15 years, and the answer is, you would have more than \$100 trillion. So either this individual is going to be master of the universe or we are going to begin to educate people more about what is happening out there, and I think there are some advertising guidelines that could be applied and there could be ones that are introduced anew to make sure that the message of what the real service is, if there is any, is out there.

Senator LEVIN. A final question. Mr. Hillman, I think it was your testimony which indicated that the SEC's Office of Internet Enforcement in 1996, I believe you said, got 10 to 15 E-mail complaints a day and that now that is 200 to 300?

Mr. HILLMAN. That is correct.

Senator LEVIN. That means that the SEC's Office of Internet Enforcement is now receiving complaints about fraud or misstatements to the tune of 50,000 a year, roughly, the way I multiply. I do not know if that fits your—

Mr. HILLMAN. An awesome number.

Senator LEVIN. The Chairman corrects me, because it is 7 days a week, so you are right. I was just multiplying 5 days a week. I am old fashioned. But it is more like 70,000 a year. How many people do they have in their office to handle that?

Mr. HILLMAN. The Office of Internet Enforcement has three full-time staff and 125 volunteer staff within SEC's Enforcement Division and regional offices.

Senator LEVIN. Well, we can ask the SEC this tomorrow, but there is no way that is anything other than overwhelming. They cannot possibly come close, even with all the volunteers, to handling that kind of a crush of complaints. So I think we are going to need to do a lot of education, but we are also going to need to do an awful lot of shoring up our enforcement mechanisms and maybe look at the penalties, as well, in order to get at the frauds and the scams which are swamping the Internet these days, so thank you.

Senator COLLINS. Thank you, Senator Levin.

To follow up on a point that Senator Levin made, we asked the SEC how many of those E-mail complaints relate to Internet fraud schemes as opposed to other kinds that are just being conveyed, and the estimate was that it was about 70 percent did. So it is a substantial and growing number.

Senator Edwards.

Senator EDWARDS. Thank you, Madam Chairman.

I have just made a list of the broad categories that I have heard the three of you talk about. I am going to go back and ask you a couple of questions about these, but what I have got are fraud, day trading, penny stocks, micro-cap stocks, "pump and dump", and I guess to some extent, anonymity contributing to those things. Have I left out some broad category of problems that you all are seeing? What have I left out? Is that it?

Mr. GARDNER. When we can nail those, we are on the road.

Senator EDWARDS. All right. And I think I have heard at least Mr. Gardner and Mr. Hillman say, particularly when you were pressed about some specifics about potential regulations and so forth, that investor education, you think, is critical, and Mr. Gardner, I know you said that in your opening comments. Professor Friedman, do you agree with the two of them about that?

Mr. FRIEDMAN. I agree that investor education is critically important. I am not sure that it alone is enough.

Senator EDWARDS. OK. I want to come back to that in just a minute. Mr. Hillman, since you are one of the people who talked about that, can you give me some notion in your mind what the components of investor education need to be, and also, second, the

practical way of getting that information to people, to potential investors, to make sure that they have got it?

Mr. HILLMAN. I think to avoid scams, education needs to be put forth that tells individual investors to think twice before investing on information learned solely over the Internet and to get the facts. Get financial statements and analyze them. Verify claims about new product developments. Call suppliers or customers of the company.

There are a number of ways that this information could get out. The SEC has a Web page containing investor education information, including warnings on investment recommendations over the Internet. They also produce pamphlets and they host town meetings.

Senator EDWARDS. Can I interrupt you there just a moment? Do not lose your place, but I want to ask you about that. Do you have any notion of how many investors who participate in purchasing the kinds of things that we have been talking about over the Internet actually go to those places to get information now?

Mr. HILLMAN. I do not have the numbers of the hits that have been made on their Web page, and I am sure the SEC could provide that to you.

Senator EDWARDS. Do you have any sense of it?

Mr. HILLMAN. I am sorry, I do not.

Senator EDWARDS. You do not know? OK. Again, back to that list of things that you talked about as being critical, in the ideal world, where would you put that information to make it most obvious and most accessible to the investor? Instead of making him go somewhere else, I mean, you are talking about going to some SEC Web site, instead of going somewhere else, where would you put it to make it most obvious and most accessible?

Mr. HILLMAN. In my opinion, I would put that information right in the investor's face while that individual is attempting to make investment decisions, and that is why I think Senator Levin's comment about providing information on the Web sites as to where to go in the SEC to get information on prospective investments is something that we ought to consider.

Senator EDWARDS. Do you have any idea, Mr. Gardner, how many Web sites, or does anybody do that now, what Mr. Hillman just talked about?

Mr. GARDNER. We are doing our darndest at The Motley Fool.

Senator EDWARDS. Besides you.

Mr. GARDNER. I generally think that if you can place it in the application for a brokerage account. Obviously, placing it at the high school level as a core requirement to graduate would almost guarantee that things like, if I may list a few educational items that would be wonderful if everyone knew. Today, \$6,000 in credit card debt is the average for an average American household, \$6,000 in credit card debt at 18 percent interest rates, which is just terribly unfortunate. Ninety percent of mutual funds charging eight times more than an index fund, 90 percent of them do worse than the market's average in the 1990's. And brokers today are still paid on commission, many of them entirely on commission, and that is something a lot of individuals do not do going into the game of planning for their retirement.

So to the extent that we can get these items out, as well as information about how to use the on-line medium to their maximal benefit, I do concur that we have to make sure to explain the Internet, a new medium and the most powerful medium in our world's history. However, so much of this has existed in some form or another before the Internet. So we have to recognize we have been unable to address it in advancing the Internet. To the extent we can with this—but let us also make sure to focus on the schools.

Senator EDWARDS. Mr. Hillman, I interrupted you. Could I go back and let you finish, or did we cover what you intended to say?

Mr. HILLMAN. No, I pretty much covered everything that I intended to cover. The SEC has provided a number of pamphlets. They have hosted town meetings. They have their own internal Web site which provides information on how individual investors are being scammed and how to avoid such scams. To the extent that that information can be made more readily available to the investing public, the better off we will be.

Senator EDWARDS. Professor Friedman, I did not miss it in your testimony. You believe that this investor education is important, but also apparently believe that there may be other steps that are necessary.

Mr. FRIEDMAN. That is right. I mentioned there is a high school program that the Investor Protection Trust and the NASD and NASAA have begun. I think getting students at high school age is certainly a good starting point.

Senator EDWARDS. Did I not also hear you talk about some sort of heightened broker-dealer responsibilities?

Mr. FRIEDMAN. Yes.

Senator EDWARDS. Talk to me a little bit more about that, because I want to get these other gentlemen's comments about whether they think that is realistic or not.

Mr. FRIEDMAN. To some extent, that goes to the day trading issue, of making certain that customers who are engaging in day trading are only doing it if it is suitable to their financial needs and their investment goals. But also more broadly, broker-dealers and investment advisors should have to monitor customers' trading to make sure that it is consistent with the customers' goals and objectives. This would extend suitability obligations beyond just the situation where brokers make recommendations, which is now the case.

Senator EDWARDS. Which you talked about with Senator Collins.

Mr. FRIEDMAN. Yes.

Senator EDWARDS. Mr. Hillman, is that practical from your perspective?

Mr. HILLMAN. In my opinion, intermittent monitoring is something that ought to be looked into. As I indicated before, broker-dealers who have a track record of providing improper information to investors are now required to have their telephone conversations with investors taped to better understand the extent to which proper information is being provided.

Senator EDWARDS. Mr. Gardner, how about your comment on that?

Mr. GARDNER. I am hesitant, again, to try and place guidelines on investment strategies, what works and what does not and to



cookie-cut the way people can invest. I think at some point you might have a broker saying to Bill Gates, you can no longer hold 99.9 percent of your wealth in a single stock. So I am not sure—

Senator EDWARDS. Can I interrupt you for just a minute? You see, my concern is, as much as I—and I very much want to protect investors, particularly elderly investors and people who are being taken advantage of—Professor and Mr. Gardner, I just worry about the practicality of it. These guidelines sound very subjective and very amorphous to me, and trying to enforce them with broker-dealers seems like an awfully hard thing to do to me.

Mr. GARDNER. I think it would be extremely difficult, but I have sympathy with the intent. But I think the execution of that idea would be very difficult. I do think that you have to try and shed as much light on this industry as possible, and to the extent that the SEC is doing that, we are going to see a greatly improved marketplace in the years ahead. But we are on the cusp here of a new medium that has been created and there may be a need for more requirements in terms of disclosure and, again, making sure that these sites shed light on what their activities are.

Senator EDWARDS. Professor Friedman, I want to give you a chance to respond to the concern I just expressed.

Mr. FRIEDMAN. There is one distinction we have to keep in mind that I think maybe we are running together. One problem is the pure fraud situation, where someone is just misrepresenting information.

Senator EDWARDS. Right.

Mr. FRIEDMAN. A second issue is trading opportunities, trading strategies, investments which are legitimate but high risk, and—

Senator EDWARDS. Day trading, for example.

Mr. FRIEDMAN. Yes, day trading or start-up companies, and those may be perfectly legitimate investments for some investors but not for others. I think we have to deal separately with those two kinds of issues, the legitimate investment that is too risky for some people versus the fraudulent investment that nobody ought to be getting into.

I think the enforcement is always a problem, but that is a problem now with suitability obligations. That enforcement problem is limited to some extent by being handled largely through arbitration when there is a violation so that it does not give rise to some of the proliferation of lawsuits that we might otherwise have.

Senator EDWARDS. One thing I have not heard any of you mention, and I may have just missed it in your testimony, have there been any problems with computer hacking in this area?

Mr. GARDNER. We have not encountered any, but certainly security is always an issue. So we have not run across that.

Senator EDWARDS. You have not seen it, but there is always the potential for that, obviously.

Mr. GARDNER. Sure.

Senator EDWARDS. How about you, Mr. Hillman?

Mr. HILLMAN. We have asked some of the on-line firms that we interviewed during the course of our study whether or not they have been penetrated and the answer so far has been no.

Senator EDWARDS. OK. Professor Friedman.

Mr. FRIEDMAN. I do not know of any situations.

Senator EDWARDS. Thank you all very much. It has been very helpful.

Senator COLLINS. Thank you.

Senator EDWARDS. Thank you, Madam Chairman.

Senator COLLINS. Thank you. Mr. Gardner, this morning when I accessed your Web site, I read your very lengthy and complete disclaimer where you make very clear to people that you are not acting as investment advisors and you tell people that, essentially, they are acting on any tips that they hear at their own risk and they should do further research and you really go to great pains to make sure that people are not confused by the role that your on-line financial forum is playing.

Some have suggested that perhaps chat rooms, the sponsors of chat rooms, should be registered as investment advisors. That strikes me as being regulatory overkill and not a very practical solution. But what about requiring on-line financial forums to have the kind of disclaimer that you have where they make very clear that they are not acting in that capacity? Would you support that kind of move?

Mr. GARDNER. Do we get a licensing fee? [Laughter.]

No. I certainly would support requirements of disclosure about the service, the responsibilities of those people providing the service, and I hope we have set a good example. I mean, in all of this, I always feel that there may be a need for regulation up front, but I would only position that regulation as something that gets peeled away over time, in other words, not denying ourselves the responsibility that we have to educate people to do this as much as possible themselves.

So any sort of requirements that are placed, I would hope that they would only be placed because we had already applied the existing law that we had as best we could, that we had enforced it, that we had seriously penalized those who had violated it, and then if there was a need for additional regulation, I would hope that education could supplant it over time.

Senator COLLINS. Professor Friedman, you mentioned in your written testimony a new kind of spam that I had not been familiar with which I want to get on our hearing record so that others can beware of it, and that is the so-called misdirected E-mail spam. This struck me as much more sophisticated than the normal spam. Could you explain how this works?

Mr. FRIEDMAN. It is. It leads the person who receives an E-mail message to think that he or she has been the lucky recipient of inside information that was intended for someone else that got misdirected to that person. It is, of course, sent out to millions of people, but it looks like an internal memo from a brokerage firm or some message that has inside information in it.

Senator COLLINS. So rather than being a direct pitch to buy or to invest, in fact, this gives the impression that, somehow, the E-mail recipient is the lucky recipient of inside information that will give them an advantage if they act now.

Mr. FRIEDMAN. That is right, and it plays on this idea that, gee, that is how people make money, by using inside information.

Senator COLLINS. Which is an interesting point, because I think there is a common perception about that among investors, and

that, somehow, if only they had the inside information, they, too, would make a lot of money.

Mr. FRIEDMAN. That is right.

Senator COLLINS. Is this a growing kind of spam?

Mr. FRIEDMAN. I do not know. I think this has been fairly limited so far. I only have heard of a few instances of it. So I think it is a little more sophisticated than the schemes carried out by most of these fraudsters have done. In fact, a lot of these schemes are pretty simple, straightforward frauds and not nearly that sophisticated.

Senator COLLINS. Mr. Hillman, I want to turn back to the issue that Senator Levin touched on as far as the adequacy of the SEC resources and efforts in this area. I have been impressed by the proactive response of the SEC to crack down on Internet fraud. It is, however, a growing problem and the question is whether the resources, no matter how well intentioned the SEC may be, are keeping pace with the problem. What is your assessment of that? Are the resources adequate? You mentioned there are only three full-time SEC staff people who are dedicated full-time to Internet fraud, though they are supplemented by 125 volunteers.

Mr. HILLMAN. It is clear to me, as well, that the SEC is trying hard to combat Internet securities fraud, but you have to wonder, while they are fighting a good battle, are they winning the war? At this early stage, it seems that the potential for Internet securities fraud is unlimited, while we know the SEC's resources are not. With the rapid growth of the Internet, it is constraining the agency's ability to respond, and as a result, they are having to focus on what they call message cases as opposed to looking into every investigation, as they probably should.

Senator COLLINS. One step that the SEC has taken, and it goes along with Mr. Gardner's theme about consumer education, is sponsoring town meetings. I was pleased to host one in Maine. The overriding message that was conveyed by the SEC Chairman was to not give money to people you do not know. I am wondering if one of the lessons that we should take from these hearings is that that basic rule has not changed and that even if it is an investment opportunity over the Internet, if it is a company you have never heard of and someone you do not know, that you ought to really think twice. Mr. Gardner, what do you think of that advice?

Mr. GARDNER. I entirely agree, although I would have to add somewhat foolishly that we have had a lot of people come into our forum and contribute to our "my dumbest investment" discussion, which is a single folder that we have that is very popular and rich with education for anyone who wants to sit down and read through it, that there are a lot of people who work with people that they do know, that are their college friends. Ed McMahon came on our radio show about a month and a half ago and said that he lost \$1.4 million investing in a psychedelic paper design company run by a college buddy of his.

Senator COLLINS. Maybe he will enter one of those sweepstakes that he is always promoting and win it all back.

Mr. GARDNER. I will not go into any detail there. [Laughter.]

But one thing that did strike me about the testimony of the two individuals that had been victims of scams is that to the extent that we can show the different sorts of investments and teach peo-

ple how to read financial statements, even though it can appear to be somewhat boring, that would have tipped them off right away that the promise of owning the world by a tiny little company is so unlikely relative to everything else that goes on in the business world, that I think that would have helped them avoid that.

Senator COLLINS. Professor Friedman.

Mr. FRIEDMAN. I am sorry. You were asking me——

Senator COLLINS. What advice do you have as far as it is a mistake for people to invest in a product they have never heard of with a company they cannot verify and with someone they do not know? I mean, does it really come down to that being the bottom line?

Mr. FRIEDMAN. Well, that is certainly a lot of it. That has been the case even before Internet fraud, that fraud carried out through the telephone, carried out in other ways, often involves exactly that same thing. That is a very basic proposition. You are right. Much of that is what we have here. Much of it is, again, just convincing people that there is no such thing as getting rich quick without huge downside risk.

Senator COLLINS. Mr. Hillman.

Mr. HILLMAN. I think the bottom line is, get the facts.

Senator COLLINS. Thank you. I want to thank the three of you for participating in our hearing today. You have greatly added to our understanding of this problem. Tomorrow, we are going to hear from State and Federal regulators.

As we approach this issue, we are mindful of the many benefits of the Internet. In many ways, I think it is helping to democratize our markets and make them more accessible to the average person, to the person who did not previously have access to the kinds of information that only securities professionals would have. And so in many ways, that is a very positive development that has been brought about through the Internet.

On the other hand, we have also seen the dark side, as Mr. O'Kane so aptly called it, of people investing through the Internet in a venture that they never would have invested in had it been through a cold call from an aggressive broker or even through a solicitation in the mail.

We have heard examples of how the perpetrators of securities scams in some ways seem to have simply packed up their operations and moved to the Internet frontier, and indeed, the Internet offers many advantages over the traditional means of communication. It is much cheaper. You can reach many more people than you could through calling from a boiler room, for example. So instead of cold calling families one at a time as they are sitting down to dinner, now these fraudsters can with the click of a mouse instantly communicate with hundreds of thousands of people via the Internet.

As we address this issue, I am convinced that, as Mr. Gardner has said, that consumer education is front and center, but I also think we need to look at questions such as whether the SEC has adequate resources, whether penalties need to be increased, whether suitability requirements need to be toughened, as Professor Friedman suggests, and we need to look at the whole panoply of possible solutions.

I very much appreciate your joining us today as we explore this very interesting issue, and with that, the hearing will now be in recess until 9:30 tomorrow morning.

[Whereupon, at 3:41 p.m., the Subcommittee was adjourned, to reconvene at 9:30 a.m. on Tuesday, March 23, 1999.]



## SECURITIES FRAUD ON THE INTERNET

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TUESDAY, MARCH 23, 1999

U.S. SENATE,  
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,  
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,  
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:31 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Susan M. Collins, Chairman of the Subcommittee, presiding.

Present: Senator Collins.

Staff Present: Timothy J. Shea, Chief Counsel/Staff Director; Mary D. Robertson, Chief Clerk; Lee Blalack, Deputy Chief Counsel; Elliot Berke, Counsel; Kirk E. Walder, Investigator; Smokey Everett, Detailee/Secret Service; Wesley Phillips, Detailee/GAO; Bob Roach, Counsel to the Minority; Butch Burke (Senator Stevens); Seema Singh (Senator Specter); and Peter Ludgin (Senator Lieberman).

### OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. Good morning. The Subcommittee will please come to order. This morning, we continue our investigation into securities fraud on the Internet.

Yesterday, we heard troubling testimony from two unfortunate investors who have firsthand knowledge of Internet securities fraud. We learned that even computer-literate, experienced investors can be bilked out of thousands of dollars through investment scams perpetrated over the Internet.

We also received testimony yesterday from the General Accounting Office, the law professor who wrote *Securities Regulation in Cyberspace*, and the founder of an on-line financial form.

Today, we will turn our attention to the efforts undertaken by both Federal and State securities regulators in response to escalating Internet securities fraud. Both the SEC and many State regulators have been inundated with consumer complaints alleging securities fraud. The SEC's Office of Internet Enforcement receives between 200 and 300 complaints via E-mail every day, of which an estimated 70 percent allege Internet securities fraud.

One question the Subcommittee will explore this morning is whether the SEC has sufficient resources to combat this burgeoning problem.

For 5 years, I served as Maine's Commissioner of Professional and Financial Regulation, with jurisdiction over the State Securities Division.

I well remember how hard our staff worked to obtain restitution for elderly consumers who had invested in penny stocks and other unsuitable investments. The Internet greatly extends the reach of con artists creating many more potential victims.

Given my experience at the State level, I am particularly interested in learning what State regulators are doing to fight Internet fraud. I look forward to hearing from our witnesses this morning as they offer the Subcommittee their perspectives on how the regulators are approaching securities fraud on the Internet and how investors can best protect themselves from falling prey to on-line securities schemes.

I do want to explain the absence of other Subcommittee Members this morning. Many of the Subcommittee Members who have a particular interest in this issue, such as Senator Levin, Senator Specter, and Senator Lieberman, are at the White House for a briefing on Kosovo that the President scheduled last night, and we did not have the opportunity to move the hearing. I hope that some of them will be able to join us later in the hearing, but I know all of them will look forward to reviewing the hearing record with great interest.

Today, we are pleased to have a panel of distinguished witnesses who will discuss Federal and State regulatory efforts to combat Internet securities fraud and to educate consumers about the risks associated with investing over the Internet.

Our first witness this morning is Richard H. Walker, who is the Director of the Division of Enforcement with the Securities and Exchange Commission.

It is my understanding that John Stark, who is the Chief of the SEC's recently created Office of Internet Enforcement, is also available to respond to questions.

Our next witness will provide a perspective on State regulatory efforts to combat Internet securities fraud. Peter C. Hildreth is the President of the North American Securities Administrators Association, or NASAA as I have always known it as, and he is also the Director of Securities Regulation for the State of New Hampshire—a fine New England State.

Mr. Hildreth is accompanied by Philip Rutledge, who is the Deputy General Counsel of the Pennsylvania Securities Commission, and I do want to thank Mr. Rutledge also for being here. He has 20 years of experience in the field of securities regulation, and I know that Senator Specter will be reviewing your testimony with great interest.

Pursuant to Rule 6, all witnesses who testify before the Subcommittee are required to be sworn in. So, at this time, I would ask that you stand and please raise your right hand.

Do you swear that the testimony you are about to give the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. WALKER. I do.

Mr. HILDRETH. I do.

Mr. RUTLEDGE. I do.

Senator COLLINS. Thank you.

We will make your complete written testimony, which in some cases is quite extensive, part of the complete hearing record. I am



going to ask that you limit your oral presentations to no more than 10 minutes each. However, if you do need a little extra time, feel free to take it, and as I mentioned, your prepared testimony will be printed in its entirety in the hearing record.

Mr. Walker, thank you for being here today, and I will ask that we start with you.

**TESTIMONY OF RICHARD H. WALKER,<sup>1</sup> DIRECTOR, DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC, ACCOMPANIED BY JOHN R. STARK, CHIEF, OFFICE OF INTERNET ENFORCEMENT, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC**

Mr. WALKER. Thank you, and good morning, Chairman Collins.

I am Richard Walker, the Securities and Exchange Commission's Director of Enforcement. We commend you, Chairman Collins, and this Subcommittee for holding today's hearing. The hearing focuses on one of the greatest challenges that we regulators face today, and that is policing the Internet.

It is a problem that has grown in magnitude and promises to command ever more of our time, resources, and ingenuity in the years ahead, and we are pleased to share with you what we have been doing in this area. We are very proud of the accomplishments that we have made so far, and we would be happy to respond to your questions.

I understand that today's hearing will be broadcast worldwide on the Web, and with that spirit in mind, we have prepared a computerized PowerPoint presentation for the Subcommittee.<sup>1</sup>

I would like to begin with a brief overview of my testimony. I am going to first talk about the types of securities frauds that we have been seeing on the Internet. Then I will discuss briefly the SEC's response to combatting fraud on the Internet, and finally, I will talk about some of the current and future regulatory and enforcement challenges that we are grappling with.

To put things in the proper perspective, I think it is appropriate to say a few words about the phenomenal growth of the Internet. There are currently about 150 million Internet users worldwide. That number is expected to double this year alone; by the end of the year, there will be about 300 million users.

Thirty-seven percent of all retail trades are currently done online. That number is up from about 17 percent in 1997.

The Internet has unquestionably provided valuable benefits to investors. It has enabled Internet users to directly communicate with all reaches of market participants, shareholders, officers and directors of public companies, and other investors.

It has also provided direct and instant access to market information 24 hours a day, 7 days a week, which is another terrific benefit for investors.

The Commission itself has made vast amounts of information available over the Internet through its Edgar database, which is available on our Web site at [www.sec.gov](http://www.sec.gov). Unfortunately, with the

<sup>1</sup> The prepared statement of Mr. Walker appears in the Appendix on page 139.

<sup>1</sup> See Exhibit No. 2 in the Appendix on page 318.

rapid growth of the Internet, we have also seen an increase in fraud on the Internet. This has emerged as a considerable challenge for our division.

We have brought so far 66 cases since we first began surveilling the Internet in 1995. Thirty-eight of those cases were brought last year in 1998. All of the cases allege fraud. They are serious cases.

Now, what is Internet fraud? There is nothing new on the Internet. We are seeing the same scams, just a new medium. As a result, we have seen phony offerings of securities, pyramid and Ponzi schemes, market manipulations which we call "pump-and-dump" schemes, and unlawful touting.

Now, Internet schemes can often be quite exotic, as witnessed in some of the first cases that we brought. For instance, we saw a scheme involving a partnership to sell eel farms. Another one involved coconut plantations which manufactured Coco Loco Chips.

I think as both Chairman Collins and Senator Levin indicated yesterday in their opening remarks, the Internet provides an aura of legitimacy and credibility which allows these schemes to take place.

One of the more recent schemes that we saw was the exploration of near-earth asteroids in a case called *SEC v. Spacedev*. Now, not only can Internet schemes be exotic, they are also quite complex.

One recent case involves a foreign currency trading scheme which raised \$3.7 million from over 40 investors. Another involved the sale of prime bank securities, which raised \$4 million from another small group of investors.

One of the favorite tools for those now engaged in market manipulation is the Internet. We have seen at least 18 market manipulation cases on the Internet raising billions of dollars.

The SEC has adopted a five-pronged approach to combatting fraud over the Internet. The first prong is aggressive surveillance, principally through our cyber force of volunteers throughout the country. We also engage in vigorous prosecution. Investor education is another key prong of our program. Liaison with other law enforcement officials at both the Federal and the State level is the fourth prong. We have worked closely with the FBI, the Secret Service, the States, and increasingly criminal prosecutors. And finally, self-policing, principally through our Enforcement Complaint Center. We have operated our Enforcement Complaint Center since 1996, and it is available on our Web site.

We currently receive, as Chairman Collins noted, between 200 and 300 messages a day. About half of the messages that we receive relate to existing investigations, and those are quickly transmitted to the staff that is handling those investigations. Overall, about 70 percent relate to fraudulent conduct on the Internet.

Now, the Enforcement Complaint Center provides a user-friendly complaint form for people to fill out or people can make their own messages and E-mail them to us. This is an example of our enforcement complaint form.

Our Web site also contains valuable investor education materials, such as this cyber alert which contains tips for on-line investing.

Another investor education posting offers valuable advice regarding investing in micro-cap stocks, which is, I know, another concern and interest of this Subcommittee.

At the SEC, we have been patrolling the Internet since 1995. Recently, we created an Office of Internet Enforcement to focus, coordinate, and expand our internal enforcement efforts.

The office was formed in July 1998. I believe that there has been some misconceptions about exactly what this office does.

The office is currently staffed by three individuals who are all Internet experts, and we intend to grow that staff over the years ahead. But the three people that staff this office are not the sum and the total of the SEC's commitment of resources to fighting fraud on the Internet.

We have an enforcement staff of approximately 850 nationwide who bring all kinds and manner of cases, including cases involving Internet fraud. It is the duties of the Office of Internet Enforcement to coordinate the activities and to provide assistance to our larger staff throughout the Nation.

In addition, the Office of Internet Enforcement oversees our 125-person cyber force, also located throughout the country, that conduct surveillance. And finally, it manages our Enforcement Complaint Center, where it receives, attends to, and promptly dispatches the complaints that we receive.

Now, one of the first dividends of establishing this office occurred this past October when we brought a coordinated sweep of cases on October 28, 1998. The sweep was the first systematic operation by the SEC to combat Internet fraud. It was coordinated by the Office of Internet Enforcement, but involves a nationwide attack with cases brought by our headquarters office and all of our regional offices throughout the country.

The focus of the sweep was on illegal touting. Now, what makes touting a security illegal? The law provides that it is unlawful to publicize a security if you are being paid to do so, unless you disclose three things. The first thing is the nature of the compensation you are receiving, whether it is cash or whether it is stock. The second thing is the amount of compensation, and the third is the source of the compensation, presumably from the company that you are touting.

Our sweep was highly productive. We filed 23 cases on the same day against 44 different respondents and defendants. The respondents and defendants included all major participants in the Internet—authors of spam or junk E-mail, on-line newsletters, message board postings, and Web sites.

The totals were quite eye-opening. The touters received from micro-cap companies more than \$6.2 million in cash alone, plus more than 1.8 million shares of stock and options which had potentially unlimited value. Touters also touted more than 235 micro-cap companies.

The sweep achieved the intended results. It sent a powerful message which was heard loud and clear and which has resulted in substantially improved disclosures. We have checked the disclosures very carefully subsequent to the sweep, and we found that people have heard the message that we have sent and they have improved substantially the disclosures. The disclosure is not at the

point that we would like to see it, but it is better. We continue to be vigilant.

We also received a record number of visits to our Web site when we announced the sweep, particularly to our consumer and investor alert on on-line investing.

We also got a surge in messages to our Enforcement Complaint Center. Before the sweep, we were receiving about 120 a day. In the few days following the sweep, the number went to 800 to 900, and it has now settled back to 200 to 300.

The sweep also created a very positive buzz among Internet users. They were aware of what we did, and I think that they learned from the message we were sending. That is evident from the following message, which is an example of one of the messages we received after the sweep.

Notwithstanding improved disclosure in this area, our work is not done, and we are going to continue to be vigilant. The best proof of that is a follow-up sweep which we announced just recently on February 25. We brought four more cases involving unlawful touting against 13 defendants and respondents who had touted 56 different companies without making proper disclosures. The kinds of frauds I have discussed so far are not new. They have been around for many, many years.

In addition, we are looking at existing and currently evolving types of conduct to which we call the new frontiers. Those include things which have been widely discussed in the press—on-line trading and day trading.

We have identified approximately 100-plus firms that are engaged in on-line trading, and we define on-line trading as a situation where the Internet simply substitutes for a telephone. Rather than telephoning in an order, an investor uses the Internet to transmit the order to a broker, who executes the order.

We have several concerns in this area. The first concern is operational capacity. Are the firms capable of handling the orders that they receive? The second is the quality of disclosure that the firms are providing. Are investors alerted not only to the benefits, but also to some of the limitations of on-line trading? And third is investor education. Do investors know what they are doing? Are they at risk of losing their money simply because they do not understand how on-line trading works?

Distinct from on-line trading is a phenomenon called day trading. By day trading, we refer to firms that do one of three things. Either they provide direct access to markets, they train people, or they make recommendations to individuals who are engaged in what we call day trading. Day trading is a strategy of rapid buying and selling to take advantage of small price movements during the course of a particular day. Most day traders buy and sell during the day and do not carry overnight positions.

We have a number of concerns which we have identified with respect to day trading. They include: Are the margin requirements of the law being satisfied? Are borrowing limits being exceeded? Second is disclosure and suitability. Are recommendations complete and consistent with an investor's ability to bear risk? And third, finally, are registrations to provisions requirements being met? Should any of these entities that are engaged in this kind of activ-

ity be required to register with our agency and be subject to the protections of the Federal securities laws?

I see that I have exceeded my time, but at this point, I will—

Senator COLLINS. You are free to finish.

Mr. WALKER [continuing]. Conclude, and I appreciate the opportunity to respond to any questions that the Subcommittee has.

Thank you very much.

Senator COLLINS. Thank you, Mr. Walker.

If you did have some additional points you wanted to make right now, please feel free to do so.

Mr. WALKER. That concludes my opening remarks. Thank you.

Senator COLLINS. Thank you. Mr. Hildreth, welcome.

**TESTIMONY OF PETER C. HILDRETH,<sup>1</sup> PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., WASHINGTON, DC**

Mr. HILDRETH. Thank you, Chairman Collins.

I am Peter Hildreth, Director of Securities Regulation for the State of New Hampshire and President of the North American Securities Administrators Association.

I am pleased to have the opportunity to present the States' perspective as you examine the issues related to securities fraud on the Internet, as well as on-line trading issues, and I am especially happy that you also have a representative from one of our more active States in that area. I am sure Phil Rutledge will do a good job for us.

As you pointed out yesterday, the legitimate business opportunities for financial services on the Internet are unlimited. At the same time, however, the risks for fraud are great. With a click of a mouse, con artists can reach tens of thousands of people via E-mail literally for pennies. They can hide their identities and locations through fictitious names, multiple aliases and remailers. Because the Internet is so cheap and reaches so many people, truly any con artists not on the Internet should be sued for malpractice.

Given the size and growth of the Internet, regulators cannot police it alone. It is like expecting one precinct house to patrol all of New York City. State and local governments have limited resources and defined jurisdictional boundaries. That is why we have asked investors to become partners with us in the fight against securities fraud on the Internet.

When I became NASAA President last fall, I announced NASAA would create a new E-mail address for investors to report suspected Internet securities fraud. The address is cyberfraud at nasaa.org.

In just 4 months, we had received over 4,700 unsolicited E-mail messages, or spams. The two messages that you have before you today are typical, and they contain uncanny similarities.

An informed investor would be very skeptical about such hyperbole. Both messages contain claims that are not supported with data. Who is recommending the stocks? Who is rating the stocks? There is no disclosure of such information, but these messages are

<sup>1</sup> The prepared statement of Mr. Hildreth appears in the Appendix on page 179.

on the Internet with a link to Yahoo!, the leading search engine, which lends them an air of credibility.

State securities regulators have been policing Internet-based investment scams for years. One great advantage of State securities regulators is their authority to use an undercover operation to detect fraud on the Internet.

My written testimony elaborates on various actions brought by a number of States since 1994, but last fall, NASAA and 30 State and provincial jurisdictions participated in the Internet Investment Opportunities Surf Day looking for suspicious or fraudulent investment opportunities. Also taking part in the Surf Day were regulators from the FTC, the CFTC, and the NASD.

Just 2 weeks ago, NASAA joined with other Federal, State, and local law enforcers to announce 33 law enforcement actions against 67 defendants promoting Internet pyramid schemes.

My advice to investors going on-line is ask yourself, if it is such a great money-making idea, why is someone telling 100,000 of their closest friends about it on the Internet. Never make a decision to buy or sell an investment product based solely on information you read on the Internet.

There will never be enough regulators to keep the on-line world free of fraud and abuse. Investor education is the key to protecting investors on the Internet.

Here are some tips that we offer. Do not expect to get rich quick. Do not buy thinly traded, little known stocks on the basis of on-line hype. Do not get suckered by claims about inside information, and certainly, call your State or provincial securities agency.

Turning briefly to on-line investing, an estimated 5 million investors have on-line brokerage accounts, and that is expected to top 10 million by the year 2000.

Not surprisingly, the on-line brokerage industry is experiencing growing pains. Regulators have been bombarded with complaints from investors stemming from outages and computer glitches at major on-line brokerage firms.

On February 7, the State of New York announced an inquiry into on-line trading firms to find out about their computer and network capacity, contingency plans, customer complaints, and how orders are processed and executed.

State regulators have also issued the following tips for investors venturing on-line, and they are included in a brochure that we have distributed. I think there are copies in the back.

First, call your State securities regulator to see if the firm is properly registered or has a disciplinary history. Carefully read the customer account agreement. Know your rights. Learn how the software works before you make your first trade. Know where to go if you make a mistake or have a problem. Remember that technology can fail. In volatile markets, your order could be delayed, and you may not get the price you want. Consider using limit orders instead of market orders.

In conclusion, State securities regulators are committed to protecting investors and preserving the integrity of the U.S. capital markets. NASAA appreciates the interest you have demonstrated in exploring all of these issues, and we are committed to working with you as your fact-finding continues.

I, of course, will be willing to answer any questions.  
 Senator COLLINS. Thank you, Mr. Hildreth.  
 Mr. Rutledge, welcome.

**TESTIMONY OF G. PHILIP RUTLEDGE,<sup>1</sup> DEPUTY CHIEF COUNSEL, PENNSYLVANIA SECURITIES COMMISSION, HARRISBURG, PENNSYLVANIA**

Mr. RUTLEDGE. Thank you. Madam Chairperson and Members of the Subcommittee, my name is Philip Rutledge, and I serve as Deputy Chief Counsel to the Pennsylvania Securities Commission.

The Subcommittee is to be commended on the timeliness of these hearings on securities frauds on the Internet, and I am grateful for the opportunity to comment on Pennsylvania's experience.

Nineteen-hundred-ninety-five also was a watershed year for the PSC because we became involved in our first three securities fraud cases where Internet was used to solicit investors. Those cases dealt with fraudulent and misleading statements posted on Internet to solicit investors in purported coconut groves in Costa Rica, nonexistent offshore hard-currency bonds, and allegedly patented therapy to treat AIDS.

These early cases, investigated jointly by PSC and SEC, also serve to highlight the cooperation necessary between State securities regulators and SEC to combat securities frauds on Internet.

Actions related to securities frauds on the Internet now account for approximately 20 percent of our enforcement caseload. I expect this percentage to continue to increase as more persons obtain personal computers and Internet access.

More recent PSC Internet-related cases have involved pure contract trusts paying 70 percent annual interest, purported investments in electric utility licenses, and secured notes paying 30 percent annual interest.

We also have secured State court injunctions against entities using Internet to solicit investments in an offshore virtual casino and in an organization promising investors a 100-percent return of their money through offshore transactions and investments in diamond fields, gold mines, and oil wells.

To combat securities fraud on Internet, I believe regulators need to focus on several areas; first, regulatory and statutory changes. A new Pennsylvania law now automatically treats violations of PSC enforcement orders as civil contempt with penalties of up to \$10,000 per violation, and we have used this new law in an Internet-related case. This same law also provides special punitive administrative assessments for people who use telemarketing which we believe includes Internet, and we also have the ability to bar individuals from the securities business, including being promoters of new issuers. These bars may be temporary or they may be permanent.

Second, dedication of resources. PSC has dedicated full-time legal, investigative, and importantly, information technology staff to Internet cases, and have substantially upgraded its computer capabilities, including high-speed Internet access.

<sup>1</sup> The prepared statement of Mr. Rutledge appears in the Appendix on page 219.

States have the right to conduct undercover surveillance in the securities areas, as they do in other areas, and we adhere to guidelines established by the courts to conduct these operations.

Third, investor education. On the PSC Web site, we disseminate investor alerts, and there is a handout which shows some of these, but I will just briefly scroll through them. The first is an investor alert concerning warning seniors about on-line investing. That was issued in July 15, 1998. These are all available on our Web site at [www.psc.state.us](http://www.psc.state.us).

We also publicize recent enforcement actions. So, when we take an enforcement action, we immediately put it up on our Web site. Here is our recent enforcement actions, and there is a cease-and-desist order which we issued against Reliable Electric and Power, which was using the Internet to solicit investors in Pennsylvania.<sup>1</sup>

We also provide links from our Web site to other investor protection Web sites such as the National Fraud Information Center, the National White Collar Crime Center, the SEC, NASAA, and the Investor Protection Trust, which provides investor protection information. So, from our site, you can link to other sites.

Importantly, we also have a mailing list where you can sign up to register with us, and we will send you an automatic E-mail when we have updated our Web site. So, if you are looking for new enforcement activities, or whether you are looking for investor protection information, you will be automatically notified.

Fourth, regulatory cooperation. PSC participates in regularized Internet sweeps with SEC and other State securities regulators, as well as the Federal Trade Commission. This cooperation must be broadened to include industry and foreign regulatory authorities.

One of the most important actions, however, which can be taken now to help protect investors from securities fraud on the Internet is making the information maintained in the central registration depository accessible to public investors via a Web site. Investor protection would be well served if investors had this information available to them at a click of a mouse while they are surfing the Internet. The best way to counteract a fraudulent investment scam on Internet is to provide a quick and easy way for an investor to perform a baseline check with CRD of the company or individual promoting the stock or investment.

Unfortunately, public access to CRD information via the Web appears in jeopardy because the National Association of Securities Dealers, which operates CRD, believes that current Federal law relating to civil liability for public release of CRD information does not apply to dissemination of the same information via a Web site. I would urge Congress to enact as quickly as possible whatever statutory amendments NASD believes necessary to give investors access to CRD information via the Web as soon as possible.

Internet is coming into the homes and businesses of millions of Americans at a time of a booming stock market and economy fueled by consumer spending and a shifting of responsibility for retirement saving from employer to employee.

<sup>1</sup> See Exhibit No. 3 in the Appendix on page 323.



Internet is changing the way Americans approach investing. We need to be alert to these changes and the ramifications they have on investor protection.

Thank you very much for the opportunity to testify before the Subcommittee.

Senator COLLINS. Thank you very much, Mr. Rutledge.

First, I want to start by commending both the SEC and NASAA for the actions that you have taken to try to get a handle on this burgeoning problem. It is evident from the testimony we had yesterday and from your descriptions of some of the scams that you have taken action against that there is no end to the ingenuity of the con artists who are preying on people via the Internet.

My concern is that their reach is so much further and it is so much less expensive than it used to be in the old-style scams of filling up a boiler room with telephone operators who are calling families one on one at dinner time; that now we have a situation where, with the click of a mouse, a scam artist can reach literally millions of potential victims.

Mr. Walker, in the hearings that the Subcommittee held on micro-cap fraud in 1997, in the fall of 1997, the SEC's chairman testified that the SEC's enforcement staff was severely strained in its effort to detect and prosecute micro-cap securities fraud. Since that time, we have seen an explosion of Internet fraud that seems to be taxing the SEC's resources still more.

Another issue that the GAO testified about yesterday is the problem of attrition among the experienced enforcement staff. I believe, for example, in the SEC's New York office that half of the attorneys who are experienced attorneys have left for more lucrative private-sector employment.

The combination of the chairman's testimony back in 1997 and the GAO's testimony to us yesterday raises the concern in my mind about whether the SEC's resources are adequate to deal with this new medium for perpetrating fraud and also the related question of whether they can ever be adequate, no matter how many more resources we give you.

Could you commend on that issue and whether there are steps other than additional resources that the SEC could take to try to keep up with this problem?

Mr. WALKER. Certainly, Chairman Collins.

We are certainly challenged, if not strained, by the increase in fraud on the Internet. I believe that we have been highly effective through the use of leverage. We try to use the resources that we have to the greatest possible advantage. We have done that by trying to bring "sweep" type of cases where we have been able to have a large impact and really send a strong message at one time, but, unquestionably, as Internet use continues to grow, I expect that fraud will also continue to grow on the Internet as well. We are certainly going to have to assign, and we intend to assign, more resources to fighting fraud over the Internet.

What this means is that we have to rob Peter to pay Paul and take resources away from other areas, unless, of course, we do have staff increases, which I am hopeful that we will be able to do through the appropriations process with Congress. But, certainly, we do have to use our staff very effectively. We have to leverage

every single resource that we have to the maximum extent possible.

We have also found very great success in working with our fellow regulators, both at the State level and the Federal level. Through sharing information, oftentimes with criminal prosecutors who really have the biggest clubs of all of us, we have been able to, I think, achieve some real deterrence. Certainly, it has been my experience in the micro-cap area that the greatest deterrence that we have achieved has been through the threat of criminal sanctions to people who oftentimes are undeterred by the prospect of an injunction or a cease-and-desist order.

Unquestionably, going forward, we are going to have to see what we can do to enhance our staff in this area because I expect the problem will continue to grow.

Certainly, there are some legislative possibilities that could be of great assistance to us and could help us in terms of the remedies that we have available to us. Too often, we see some of the same people coming back into the industry who we have sanctioned in other capacities. One of the things that we have no jurisdiction over is people who act as promoters. The promoter population has been growing rapidly. It is also probably a pretty bad gene pool. Many people in this area have been previously sanctioned. Some have even been thrown out of the industry in terms of being associated with the broker-dealers and other entities.

To the extent that we could get and obtain remedies that would bar them from acting as promoters in micro-cap type of offerings, that would be a very effective remedy.

Another thought—forgive me for going on, but since you asked for a Christmas list, it is a good occasion to do so. We do not currently have the authority to use State law enforcement decrees and remedies at the Federal level. We can access the State's files, and that is very effective and very useful, but then we have to do our own investigations and bring our own cases. If we have the authority to use findings by a State securities administrator as a basis for a disciplinary proceeding, that would really help us be able to bring cases much faster and cut out a lot of the intermediate levels.

I might say that it has been very successful when it has worked the other way. Oftentimes, State securities administrators can take temporary restraining orders or preliminary injunctions that we obtain and immediately suspend someone from doing business in the State. That is a highly effective remedy. I think if we had greater authority to use State court and State securities regulator decrees, that would be very helpful as well.

So those are some of the things I think that would really enable us with the resources that we have to enhance our ability to deter fraud in this area.

Senator COLLINS. That was a very helpful summary of some of the issues that I would like to get into and in more depth.

I do invite you, and it is rare for a Member of the Senate to invite you to give us a wish list on your appropriation needs, but I am doing that as well, and also whether there is an issue of the pay and classification of the attorneys because, if you cannot keep your experienced staff, that to me is equally as serious a problem. So I would welcome your suggestions in that area as well, as we

seek to put together a legislative package to deal with some of the issues in this area.

I want to go back to the issue you raised of what I call rogue brokers who go from one firm to another. I saw this when I was working at the State level and the frustration that it caused my securities regulators, and also the regulators in the other financial areas in my department, insurance, for example, where we would have someone who would be barred from selling securities, switch over and sell life insurance. So I think there is an issue there as well.

Just for the record, I want to flesh out this issue. Am I correct that under current securities law, the SEC can bar a registered securities professional from serving in that capacity and from participating in any future penny stock offering, even as a promoter, or is there a gap on the promoter part?

Mr. WALKER. We have the authority to bar someone under our penny stock rules and statutes only from participating as a promoter in connection with penny stock activities. We do not have the authority to bar someone, for instance, who is associated with a broker-dealer from also participating as a promoter for a penny stock entity. So it is only with respect to penny stock-related cases that we can bar someone from being a promoter.

Senator COLLINS. In the previous hearing held by the Subcommittee focussing on micro-cap stocks, we found that people who had been barred from dealing with penny stocks were shifting over and acting as promoters for micro-cap stocks. Is that correct? Is that a loophole in the current law?

Mr. WALKER. Well, that is certainly correct. There has been a migration. The penny stock rules typically apply to stocks that sell for \$5 or less. So it is very easy for someone that wants to evade the scope of a penny stock bar to simply promote a stock for \$5.50. So there has been creep in terms of the type of dollar level in which fraudulent activity has occurred. Enlarging the scope of the penny stock rules would be another, I think, very useful possibility for Congress to address.

Senator COLLINS. Indeed, at least one of the cases in your February sweep, involved a repeat offender of micro-cap fraud. Is that correct?

Mr. WALKER. That is correct.

Senator COLLINS. It seems to me that we need to crack down in this whole area. I suggested to Chairman Levitt that we have perhaps a zero tolerance rule; that instead of giving people chance after chance or letting them migrate from one kind of stock to another or one financial field to another that we have a one-strike-and-you-are-out rule.

I had asked at that time, and it has been quite a bit of time since that hearing, whether the SEC would consider supporting that kind of enforcement action, where we would bar someone forever for dealing in the securities field. What is your reaction to that proposal?

Mr. WALKER. Well, I would not want to speak on behalf of the agency with respect to that, but I must say that the agency has been very tough. I think that the level of sanctions in this area has been increasing.

The Commission takes this message very much to heart, and I think has been imposing and expects the staff to seek very, very harsh and appropriate sanctions to the worst of the violators. This is so because we recognize that so many people who are barred and serve their time or who are barred in some capacities end up coming back into the industry in other capacities. So it is certainly something that I think we should give very serious consideration to.

Senator COLLINS. Mr. Hildreth, do you have a comment on that proposal?

Mr. HILDRETH. Well, I was going to comment that one of the things that we do in New Hampshire—and we do not have a large staff, but we have one very capable woman who goes through the licensing—we keep people out of selling in New Hampshire who have those kind of disciplinary histories when we check the CRD.

Occasionally, we let them come in with special supervision, but usually if there is the rouge broker story in *The Wall Street Journal* or the *New York Times*, Mary will come into my office with a printout and say, “Kept him out, kept him out, kept him out, was not quite enough to keep this guy out, but I had a bad feeling about him.” So it goes back. I think, also, we use that.

Another State took action against him. The SEC took action against him. It goes back to the comment that Dick Walker made about using State actions. It is a very effective tool for the States to use, and I think that the SEC and NASAA would certainly support it being extended to them, not just in the Internet area.

Senator COLLINS. Mr. Rutledge, do you have any comment on that issue? Has that been a problem in your State where people pop up from one firm to another?

Mr. RUTLEDGE. Indeed, and we took action with the new law, effective in January of this year, where the Commission as an administrative agency has the authority to ban for temporarily or permanently any person from acting in the Commonwealth as an issuer; acting as a promoter, officer, or director, or a person trying to offer to sell securities; from being registered as a broker-dealer, investment advisor, investment advisor representative or a registered representative, or as an affiliate of such person; or relying on any exemption from registration under State law. This is our response to your zero tolerance idea.

It is not a statutory mandate that everybody who has an infraction is out of the industry, but it places the burden on the regulator because they know best as to how bad this person was.

We also borrowed a provision from the Federal Penny Stock Reform Act and put liability on individuals who knowingly employ barred individuals to act in that capacity.

So, if you are a legitimate person, but then you hire a person who is banned from being a promoter to promote your next stock, you also are liable under our statute.

Senator COLLINS. It seems to me that if we can prevent the people from being in this field, that that is a lot easier than trying to chase after the fraud after it has been committed.

I know that in Maine, as well as in New Hampshire, that we placed a lot of emphasis on the registration and licensing, the pro-

visions to try to keep people out who did have a history. We would check the CRD and see if there were other State actions.

Mr. HILDRETH. One of the things that the new Web CRD—it is supposed to come on-line in August—is to allow us to track people from those bad firms so that we know where they went. You have seen the charts where they track them, but that is a lot of manpower. If we can do it with a “click of the mouse,” as is the phrase, it is going to help us find those people, where they went, and if not take action, at least have a flag there to keep an eye on them.

Senator COLLINS. Mr. Hildreth, let me follow up on an issue that Mr. Walker raised, which I think is a very good idea and something that Congress should give the SEC the authority to do, and that is, as I understand current law, as Mr. Walker explained, the SEC cannot make use of State findings when bringing its own enforcement actions.

If the SEC had the authority to follow up on State actions, presumably, the SEC could bring quick-hit actions with greater remedies against violators of securities laws, and it seems to me that that authority would be very valuable, especially since in New Hampshire or Pennsylvania, you cannot bar someone from going to another State. Only the SEC can take the kinds of national action that is needed.

So I would like to hear from Mr. Hildreth and Mr. Rutledge. Would NASAA and the State regulators support giving the SEC the authority to act based on State actions?

Do you see any problem with our changing the law to allow that, Mr. Hildreth?

Mr. HILDRETH. I do not see any problem at all.

As I have mentioned, the States use it very effectively. I think you may hear from some people that, well, how do we know that these are going to be real hearings on the State level.

I can tell you from my perspective that when I run a hearing, I am very careful to watch out for due process rights, give the people we bring in, the respondents, all of their rights, but these actions when we revoked—New Hampshire happened to be the first State that revoked a company called Investors Associates, I think, as part of the micro-cap sweep.

When we did, we held a full hearing. We revoked them. It allowed other States to take action with them, who may have had pending actions or pending complaints, but had not had enough evidence to do anything, for them to take action and stop them from selling in their State.

I think and NASAA, I am sure, would be willing to testify in favor of any legislation necessary to give the SEC that authority because, as you said, it is very quick and effective.

In this world, there is nothing better than acting quickly. When they can, as you said, hit that mouse and it goes to everyone, every day, every hour that goes by, there is another potential victim there who is going to lose money.

Senator COLLINS. Mr. Rutledge, do you see any problem with giving the SEC the authority to act based on State actions?

Mr. RUTLEDGE. I think it is a very common-sense approach to the use of our admittedly limited resources to have SEC have to duplicate an investigation when they can rely on a State court injunc-

tion or an administrative adjudication. I just think it makes plain regulatory sense.

Senator COLLINS. I also think this issue is of growing importance, given the use of the Internet, because the Internet expands the reach of these con artists so much that for one State to try to tackle the issue, it protects only the residents of that particular State. So it seems to me that giving that authority—I will say that when I look at the enforcement actions taken by the State and the SEC, it only reinforces my belief of the importance of having both regulatory systems. I know that has been an issue in the past. When we are looking at the goal of protecting consumers, it is very clear to me that we need aggressive actions on both the State and the Federal level and a lot of cooperation between the Federal and State level as well.

I would now like to turn to some of the issues that were raised at our hearing yesterday to get your reaction to some of the suggestions that were made by our witnesses.

We heard yesterday from the founder of the on-line financial forum, The Motley Fool, about the extensive efforts that The Motley Fool undertakes to monitor its on-line chat rooms and bulletin boards.

In particular, The Motley Fool very aggressively discourages speculation or talk of—I guess the word is “chat”—about penny stocks. The Subcommittee’s investigation has found that the efforts taken by The Motley Fool are not common; that Yahoo!, for example, undertakes virtually no monitoring or policing of its financial chat rooms or bulletin boards.

I would like to get all three of you to comment on the issue of whether or not on-line financial forums should be responsible for policing or monitoring their chat rooms and bulletin boards.

Mr. Walker, I will start with you.

Mr. WALKER. Thank you, Chairman Collins.

I do think that it is reasonable to have some responsibility and authority placed at that level. Certainly, the most effective law enforcement is law enforcement that occurs at various different levels. I am not suggesting that they would act as law enforcement, but they are the first layer, where the rubber meets the road, if you will. It is the first level of defense for these people to see what comes in their own chat rooms. So I applaud The Motley Fool for their efforts to do that, and I think that is certainly very helpful in terms of providing a sense to others as to what kinds of things are going on. The earlier that we can find out about situations like that, the better equipped and better prepared we are to address those kinds of situations. Time and speed are sometimes of the essence before investors are injured and before fraudulent messages and fraudulent information gets disseminated. So I think that is an excellent idea.

Senator COLLINS. Has the SEC had any discussions with on-line financial forums to encourage this kind of monitoring or policing of the bulletin boards and chat rooms?

Mr. WALKER. I am probably not the right person to ask that question because I guess, when they hear from me, they do not appreciate it. But I think that those activities are probably more likely through our Division of Market Regulation, but I honestly do not

know the answer. We would be pleased to provide you with that information.

Senator COLLINS. If you would get back to us.

Mr. WALKER. Certainly.

Senator COLLINS. Mr. Hildreth, what do you think the obligation is of the sponsors of these forums?

Mr. HILDRETH. I think there will be a hesitancy on some of those sponsors. Given the sort of gray legal areas that are out there, they are going to probably be asking you for some sort of coverage for liability.

I know there has been some cases. There is a securities case, and I apologize I do not have it in front of me, that dealt with someone supposedly defaming one of these micro-cap companies, and I think it was settled before hearing.

I think that they do have a role to play. I read The Motley Fool's testimony last night, and he talked about how there is a role when it is brought up that the Internet citizens, I guess, will come out and say, "Oh, do not do that. Make sure you go do this." So there is some self-policing there, also.

My concern would be whether you can—what has faced Congress before. How do you regulate the Internet? If you have all of the U.S. providers and you force them to regulate this, someone sets up who knows where and just connects in and we are not going to have any jurisdiction over them.

So I think that while it may be something to look at, if there is a way to get them and maybe just PR forcing them to do it, it is just so wide open. It is the wild, wild west. If they cannot get it from Yahoo!, they will go somewhere else, I guess. That is my gut feeling.

Senator COLLINS. On the issue of liability, we did receive testimony yesterday from Professor Friedman, who is a securities expert from the University of Toledo, who said that current law makes it clear that there is not liability. I know that is an issue that has been raised, but perhaps a variation of this is to have the on-line financial forum disclose if they are not monitoring or policing the chat rooms. In other words, that at least there is disclosure one way or another, and so much of our securities laws are based on disclosure.

I, too, share a reluctance for Congress to be heavy-handed in regulating the Internet. On the other hand, I am also disturbed by the fact that people tap into access these chat rooms, get this hyped information, and think that somehow it is valid. So it is a difficult balance, and maybe the answer is that if there is no monitoring or policing of the chat room, that there be a disclosure up front that that is the case.

Mr. HILDRETH. What is interesting to me is that it is not even, though, the chat rooms. It is sort of like they use other areas of the Internet to get access to an investor.

The one that was my own experience, I have my own AOL account. I signed on 1 day, and it said something about spring and seeds. My wife likes gardening. So I went to their free shop.

Well, I never got to find out what that offer was because the first thing that caught my eye was: "Alaska gold . . . Texas oil." And sure enough, it was unregistered, and I finally got the person at

AOL, their legal department, said who I was, and to their credit, it immediately came off. I mean within 30 minutes of when I had called them, it was gone, but as a result of that, they sold the list to someone else, and I am sitting at my desk in my office. The secretary says Mr. So-and-So is on the phone. So I said, "Oh, OK. Well, put him through." This guy got the list and is trying to sell me securities, unregistered securities, when they answer the phone, "Good afternoon. Bureau of Securities." I mean, they do not care, but they use those lists. They use list serves. They use bulletin boards, whatever, to get names to send you mail and contact you. So it is a wild, wild west out there.

Senator COLLINS. Mr. Rutledge, do you have any comments on whether you think there is some obligation for the on-line financial forums to either disclose that they are not monitoring the chat rooms or bulletin boards or to in fact affirmatively monitor them?

Mr. RUTLEDGE. I found it interesting from Mr. Gardner's testimony yesterday, he kind of portrayed it as a public service as on-line facilities where common folk can come and discuss things. I think if you are taking that type of public service approach, maybe as a public service, which The Motley Fool is doing, where you know of problems or you are or are not monitoring your chat rooms, that you should disclose that.

Because of the liability issues, it may evolve perhaps into something of a code of best practices for on-line forum. That could be developed, and you could link to it or you can say we subscribe to the best practices which include monitoring, or we do not subscribe to best practices, you are on your own, it is a free-for-all.

I would like to ask for some free on-line advertising banners to expose the regulators' Web sites to people who are logging on for financial information. I think that would be a great public service.

Senator COLLINS. Actually, there was one of the next issues I was going to ask you about. Two ideas that surfaced at our hearings yesterday were, one, to require there to be a link to the SEC or NASAA or State Web pages, which, by the way, I accessed yesterday and they are excellent. I think if a lot of on-line investors would read the tips for investing that are on the SEC or the NASAA Web page, they would save themselves a lot of heartache and financial ruin.

One proposal is to encourage or require that to be that link. Another proposal, which I suspect has some practical problems, was suggested by both Professor Friedman and one of our victim witnesses, and that was that there be some kind of third-party verification that a Web page is legitimate.

Professor Friedman referred to an AICPA seal of approval, if you will, that some Web pages are about to use if in fact they have been audited and verified.

Are either of those suggestions practical, the link to the SEC or NASAA Web pages, or having some sort of third-party verification? The sheer volume is the issue to me.

Mr. Walker.

Mr. WALKER. Certainly, first, with respect to third-party verification, I read Professor Friedman's testimony and found his idea to be an interesting and very potentially valuable idea if it could be achieved.



I do not think that it can be achieved by the regulatory community for the following reasons. First of all, the authority for overseeing sales of securities is dispersed between the Federal Government and the States, and no one authority would be able to oversee all of the different kinds of securities offerings. Some are registered with the SEC, others with State, and some exempt from registration.

Also, I think the AICPA model that Professor Friedman talked about was a situation in which someone actually conducted some form of audit of the various Web sites before they gave the seal of approval. That is not currently the way securities registration at the Federal level occurs. We do not audit the merits of the registration. We just simply provide that the statutory requirements have been met. We take no position on the bona fides of the particular securities being sold.

It may be the type of service that could be done by the private sector. It could be, if not a "Good Housekeeping" type of thing, somebody from the private sector that would have the funds and the ability and be able to have the stature and the reputation to do something like that, which would be a terrific service for investors. If there was one central person, even if you paid perhaps a modest fee or maybe the fee could be achieved through some other sources, it would be a great benefit for investors.

I am just skeptical as to whether it could happen at the government level, either Federal or State.

Senator COLLINS. Mr. Hildreth.

Mr. HILDRETH. I think that somehow either requiring or promoting a link to an investor protection site is a great idea, and it would seem to me that legitimate chat room locations, any of those folks, should be more than willing to do that because that is what they are really in the business of. It is getting people educated to make educated decisions, to keep the markets where they are today.

The third-party verification, I guess sometimes I think like a scam artist. Wouldn't I be able to find someone who is a good enough computer geek to take—I am not sure I should use that term. I had better be careful, but to take that certification and move it to my page, and then wouldn't I be saying—someone would log on and say this is an OK site, they have been verified? I do not know if that is technically possible, but I will bet you somebody could figure out how to do it. That is my real concern about that.

Once you give a mark that it means something, how do you protect it?

Senator COLLINS. Mr. Rutledge.

Mr. RUTLEDGE. Which is exactly our conclusion. We evaluated using medallions at the Pennsylvania Securities Commission, where we would issue a medallion to a Web site, because we have a lot of legitimate small businesses who want to post their prospectus on a Web site. We rejected it for those reasons.

If you issued it and then the Web page changed, it might change legitimately, to change the address, or it might be changed illegitimately to make alterations. It might be copied. All of those concerns have led us to the conclusion that the direction we are going is to put on our Web site a link to our registration system, so that

if you are looking at, for instance, the lady from IPS, if she had been a Pennsylvania resident, she could have clicked on our Web site, gone to our registration list, and these companies have been registered with the Pennsylvania Securities Commission. Depending on what kind of offering it was in that particular instance, I believe it was purported to be an exempt offering from registration with the SEC. It would have to have been registered under Pennsylvania law. So there would have been affirmative registration.

Like SEC, we do not pass on the merits, but there is a lot more substantive criteria that must be met for registration in Pennsylvania.

So I think in the area of the Regulation A offerings, which is \$5 million or less, or the Rule 504 offerings, which are a million dollars or less, both of which are exempt from Section 5 registration with the SEC and are registered at the State level, that that would be a more bona fide check, was it registered, and that way, the responsibility of the issuer for keeping their Web page current and not misleading remains on the issuer. So, if they changed it, we could take action against them, but at least they know there was at least a first cut, and they can always call us and say what about this particular offering, did you register it, what were your problems with it, or, more importantly, we never heard of these people.

Senator COLLINS. It was told to me that both of our victim investors yesterday were experienced investors, but they had no idea that they could have called their State securities bureau for assistance.

Mr. RUTLEDGE. That is why we need banner advertising on those Yahoo! sites.

Senator COLLINS. That is why I raised the issue because both of them—one had been investing for 10 years, one for 5 years, and I remember when I was involved in this area in Maine, we kept trying to do constant outreach so that people would know, but it is very difficult to reach every investor.

In the case of Ms. Morris, yesterday, she tried to do some due diligence steps. Had she called the California Securities Division, which is where this offering was from, she would have found that it was an unregistered offering, and would have saved herself a thousand dollars.

We somehow need to do more, and I think the Internet is an untapped resource in many ways, to make sure that investors understand that there is information available, that there is help available both at the State and Federal levels. In many ways, I think the Internet, which is being used by these scam artists, needs to be used more effectively by regulators to educate investors.

One of the strengths of the Internet, which we keep talking about, is it can reach so many people, and I would suggest that is a strength for the regulators to use in educating consumers.

Mr. HILDRETH, in your written testimony, you mentioned that States are making more use of the Internet to try to get consumer information out to investors. Could you tell us a bit about the programs? I think that you mentioned that Ohio, in particular, has a program that is very helpful.

Mr. HILDRETH. I think that government has been slower than the scam artists to use the Internet, and I guess part of that is just

the way governments work and how long it sometimes takes us to get the technology that we need.

I think the one that you are talking about in Ohio is that they are listing the bad boys, the ones that are selling in their State who are not registered there, sort of an affirmative step instead of having to call California, for example, and ask, is this a legitimate offering. There is a list that you can at least cross off. You might not get them all because the State does not know until they get a complaint sometimes who is selling in their State, but when they try to do it, they get a complaint. They say, OK, it is very simple. It is not registered. It is not exempt. It goes on the list.

I think there are several facets. NASAA, as you know, probably from your days in the State of Maine, does a lot of outreach, giving information to State securities regulators as far as fill-in-the-blank press releases. We have done a lot of those recently, and a lot of States have used them and local people have picked them up and run stories on them. So there is the press side of it, and those States, like Pennsylvania and Ohio, as the two that come to mind, that very early got involved in the Internet, probably have progressed further than a State like New Hampshire who just recently got their Internet access for their office. I am not sure what Maine is doing.

I do think that we should make more use of the Internet. I think one idea is the banners. I think the States probably need—and perhaps the SEC—they may be more restricted, but at NASAA, we have sort of a nongovernmental site here, might be able to do some negotiating with sites along those lines, to cooperate with them.

I think we need to talk to groups like Yahoo!, like AOL, some of the big-service providers, and work along those lines.

Senator COLLINS. I think that would be very positive.

What I like about the Ohio example is it names names. It is very specific.

One example that I have is about an offering called travelzoo.com, and it says, "The Ohio Division encourages investors who are considering obtaining shares in travelzoo.com to exercise caution. Please consider the following. There may be no dividend payments. There may be no current value to the shares, nor may the shares ever be traded publicly or acquire any future value. This company should not be compared to any other technology or Internet company. Projected growth in the use of the Internet will not necessarily result in future value to the company," etc.

Any consumer who read that would be very unlikely to make an investment in travelzoo.com, or if they did, they would know what they were getting into, which is fine. The problem is when investors do not understand the risks that they are undertaking.

This strikes me as a very valuable proposal, and one that also is very useful, because the consumer can do it right on the computer. They do not even have to do the long distance phone call.

Are other States moving in that area? Do you know, Mr. Hildreth or Mr. Rutledge?

Mr. HILDRETH. I would have to say that I do not know of other States who have taken that step.

I will say they would probably get, at least in New Hampshire if they called—they might get the same kind of information, but as

you said, if you are on the Internet doing your trading, it is more comfortable for you to click that button and go check it out. It is more my daughters and the little older generation. They are better Internet citizens probably than I am, but that is second nature to them, much more than it is to me. When the investors get on there and do those things, probably to sign off and call the agency is almost an anathema. So I think it is a good idea and something that we ought to talk about to other States, and I am trying to think if I can get my Web master to work on that myself.

Mr. RUTLEDGE. And they are doing it at 11 o'clock at night.

Senator COLLINS. Right.

Mr. RUTLEDGE. The children are in bed. Our offices are closed, but our Web site is open 24 hours a day.

Senator COLLINS. Exactly.

Mr. RUTLEDGE. I believe there is an obligation on the part of the regulators, us at this table and our fellow regulators, to put as much information as possible on our Web site so the public can access it.

As an example, we took an action against a company whose executive officer had been banned permanently by the SEC with any association with any securities dealer, or any securities association and was subject to a permanent injunction of a Federal court in New York. It was obviously not disclosed, and spams sent to a Pennsylvania investor who did call the Pennsylvania Securities Commission, but had that CRD information—which is where we got that information—been available on the Web. That person when he got the spam could have clicked on the Web site, put in the person's name, and found that this person was a bad person he should not do business with.

Senator COLLINS. Mr. Walker, what is the SEC doing to use the Internet beyond the investor tips, but as far as specific people that the investor should be leery of?

Mr. WALKER. What we have done in addition to the investor alerts that I have described previously is, of course, to publish every single enforcement action that we bring. That information is available on our Web site—the names, the companies, and the individuals that are involved in those actions.

In addition, we have found from time to time that it is very effective to post those releases in other locations where the frauds have occurred. So, if there are areas on the Internet where people have been solicited to buy particular securities, rather than having them have to find a way to our Web site, we have gone and posted temporary restraining orders or preliminary injunctions on other Web sites where some of the fraudulent activity has occurred. We found that to be effective, too, because it gets right to the people who have been victimized. But in all instances in which we bring cases, the names of the individuals and entities are set forth, and anyone that visits our Web site can find them going back.

Senator COLLINS. I think that is a step in the right direction.

What appeals to me, however, about what appears to be the Ohio example, which NASAA brought to our attention, is it seems to be up front before there is an enforcement action. It seems to be alerting people that if you invest, you are investing in a very high-risk venture, and be sure you know what you are getting into. Maybe

that is a responsibility that is more at the State level, but does the SEC do anything that is proactive?

Mr. WALKER. We do require those kinds of disclosures from time to time with respect to offerings of securities that are highly speculative and at risk, and those filings are available also on our Web site through our Edgar database. So it is not uncommon to see those kind of hair-raising disclosures, particularly in some of the lower end of the kinds of offerings where we see perhaps people have been disciplined in the past. Those kinds of disclosures are made, and I think, are very effective to let investors know the full risks of what they are buying.

Unfortunately, we have found that notwithstanding that, there are people that are still purchasing these kinds of investments.

I think one other thing I would add is that one of the most effective remedies we have is trading suspensions and where there is inaccurate or incomplete information in the marketplace. We are able to suspend trading in a particular security for a period of up to 10 days. We do post notices of trading suspensions in forums so that that information and knowledge gets out, dispersed widely to some of the people who have purchased or owned these kinds of securities.

Senator COLLINS. I would like to turn to another difference between State and Federal enforcement efforts.

Mr. HILDRETH, in your written testimony, you noted that the great advantage of State securities regulators is their authority to use an undercover operation to detect fraud on the Internet. A State agency can establish an E-mail address to go shopping for fraudulent Internet solicitations to obtain information to pursue enforcement cases.

Are these kinds of undercover operations a large part of State regulators' efforts to detect Internet fraud?

Mr. HILDRETH. What I like about that is it seems to use the Internet capabilities the same way the scam artists do. They do not tell you who they are. They do not tell you where they are. They use these remailers. They use aliases.

We can do the same thing, and it is simple on the Internet. It is not like you have to get a phone line and work with the phone company to get it listed to somebody else, although a lot of States also do that and it is very lucrative.

Once you get on these lists, it does not take much. You create a screen name or whatever they want to call it, and you go to a couple sites, and suddenly, you are getting mail from everybody and not just the securities scam artists. I guess they all look for the same pigeons. I do not know if it is securities or business opportunities or pornographic sites. They all say, "Well, we will jump in." So it is something that is very useful to identify before people get taken.

I am sure you saw in Maine the sad cases where people come in, and if they had just called us or if we had shut this company down just a week or two sooner—I mean, we had one woman, and one of the good stories, a half hour before she sent her certified check off with Federal Express, decided to call us and ask us about them. If we can get those scam artists and close them down before they take that woman's total liquid worth, that is what we need to do.

Senator COLLINS. We used these operations in Maine as well. I remember my securities administrator always gave his home phone number out so that the phone would not be answered, "Securities Division." It seems to the Internet greatly expands the possibilities. As one of our witnesses said yesterday, "No one knows you are a dog on the Internet." Well, no one knows you are a securities regulator either.

It is my understanding, Mr. Walker, that the Federal Government does not use those kinds of undercover operations. Why not?

Mr. WALKER. We are bound by the Privacy Act, which is a Federal law, which prohibits us from engaging in effect in undercover operations. We have to identify ourselves and who we are and what we are doing when we approach people in connection with investigations. So that is the limitation that we have confronted.

Outside the Internet, we have provided technical advice and assistance to others who are engaged in undercover operations, which has been very effective. Frankly, we are not particularly well trained, because we have never done it, to engage in these kinds of operations, though certainly the Internet, if you are simply just sort of hiding your identity, that raises concerns of a very different kind than if you are establishing an undercover broker-dealer, for instance, but currently Federal law does prohibit us from using aliases when we are on the Internet and we have to identify ourselves, but I will say that does not seem to have a limited—or disabled us from finding ample incidents of suspicious or fraudulent conduct. Location of illegal conduct, we have not been inhibited by the fact that we have to approach people, and we actually go onto the Internet and use our own names and addresses.

Senator COLLINS. Would it be helpful for you to have that authority?

Mr. WALKER. I think it could be, yes, certainly on the Internet.

I would be very cautious in seeking to expand it in other areas because, as I indicated, we are simply not equipped to engage in other kinds of undercover operations. But certainly to the extent that it would allow us to participate or engage in conversations with people over the Internet, where there are no real questions about physical security or things of that sort, it could be very useful.

Senator COLLINS. Mr. Rutledge, does Pennsylvania use those kinds of undercover techniques or establishing a phoney E-mail address?

Mr. RUTLEDGE. It is a very integral part of our enforcement effort, totally with particularity to the Internet, and as Peter said, our goal is to get the con artists out of the Commonwealth before he takes the money, and we use it extensively. We issue our cease-and-desist orders. As soon as those C&D's are issued, they go up on our Web site, and our Web site actually has—we have people coming in to tell us, "I saw your enforcement Web site. I am glad I did not invest because I have been called by this person or I had received a spam from this person." Other stories are not so good in that, "I have been spammed or I have been the victim, but here is some evidence you can use against this person," when we go to administrative proceedings. So we use it extensively.

However, the fraudsters are getting a little smarter, and there are now some sites that are off limits if they detect that you are coming from a government network. So you have to be a little more crafty in how you set up your surveillance operations.

Senator COLLINS. I would now like to turn to some concluding issues on day trading and on-line trading.

Yesterday, at least one of our witnesses expressed the concern that the explosive growth of day trading could make it much easier for “pump-and-dump” schemes, other manipulations to occur. What steps are being taken at both the State and the Federal level to deal with day trading and the problems that it poses for securities regulators?

Mr. Walker.

Mr. WALKER. Certainly, we have identified approximately 100-plus firms that are engaged in what we have identified and defined as day trading activity. Those are firms that either make recommendations to day traders, provide actual facilities that give you direct access to markets or promise to train you in that strategy and that technique.

We are coordinating examinations of those firms with the NASD, so that we have a presence in the firms. We are trying to observe the conduct and the activities of the firms firsthand.

We are looking at some of the advertising that the firms provide. We are looking at regulatory types of issues that are raised by the operation of those firms, and looking at these things very carefully.

We have not necessarily seen a nexus or relationship to “pump-and-dump” type of manipulations because, for the most part, these are very short types of positions that day traders take. They are in and out very, very quickly within the course of a day. They do not carry positions overnight. They take advantage of rapid buying and selling in small increments in terms of price changes. So those are the activities that we are undertaking right at the present time.

Senator COLLINS. The problem is if you chart the changes in some of these penny stocks, for example, that have been hyped by on-line newsletters, and if you add in the phenomenon of day trading, it seems to me, you create a very potentially explosive and exploitive situation, and that is the basis for my concern.

Mr. Hildreth.

Mr. HILDRETH. The States really do not have the resources to deal with the market manipulations. I mean, we see them. It is really an SEC need to regulate, although I think, for example, we in our State statute, have the ability, I guess, the authority, but it really is beyond us.

I think that the problem—day trading, it depends on how you define it. I guess there are a lot of day traders who are just on-line traders, and they send their deals through the computer Internet, just as if they had called their broker, and I think that they probably do impact the way the market is acting.

The day traders, where they go into a location and are trained to use the computers and place the trades themselves, the States have been very active in this, and some of you may have seen “60 Minutes II,” the other night, on day trading. Massachusetts, Texas,

and Missouri are the ones that come rapidly to mind who have taken action. Indiana recently did.

I think those are the States that have done it because that is where these day traders are located.

Senator COLLINS. What action did they take?

Mr. HILDRETH. They would have been cease-and-desist orders, but it has been mostly on unregistered activity, unlicensed activity, being a broker-dealer without getting the license to do it in the State of whatever, using unregistered agents.

It is really a small—I have heard maybe 8,000 people nationwide who do that kind of trading. Our concerns on day trading are more along that, that people are not being given the proper disclosures. In some cases, they are being told they are not clients or customers of the firm. They are actually independent contractors, and they trade on the firm's account.

There is a lot of those kinds of regulatory issues for the State. I mean, I certainly would not suggest that anyone become a day trader, but I guess there is a group of people who want to do that.

I had a friend of mine that I went to law school with ask me, "Gee, what about day trading?," and I said, "This is not what you want to do. You are doing other things. You are not going to go in and sit at this thing and risk your family's financial health on these things." It was interesting to me that that was an interest to him.

He read these articles and said, "Gee, I could do that. I could make thousands overnight."

Senator COLLINS. Well, it is the get-rich-quick appeal, once again.

Mr. HILDRETH. Right, exactly.

Mr. WALKER. If I might just add to my prior answer, Chairman Collins?

Senator COLLINS. Yes.

Mr. WALKER. We have received actually, remarkably, few complaints from people in connection with day trading. I think our biggest concern is that people are engaging in this activity that do not know what they are doing. So, once again, investor education here is so critical because losses can happen so quickly and so easily. You can place trades directly without any intermediary giving you advice or telling you whether something is good or not good. I think the "60 Minutes II" presentation really made that vividly clear.

There was one individual who had lost money and simply did not have the knowledge and appreciation of the risks that were involved. Chairman Levitt has issued a cautionary statement with respect to both on-line trading and day trading, just trying to warn people to not overlook the fundamentals of investing for trading purposes, for the purpose of getting a quick profit.

You have got to do your homework. You have got to get the facts, and you have got to know what you are doing, or you can run every much of a risk of losing money as making money. So it is a very important thing to get the message out that people should not be doing this. They should assess and understand their risk levels. They should not get in over their heads, which is possible, and, of course, we have to make sure that they are not induced to do that



through fraudulent misrepresentations of get-rich-quick or false strategies that simply do not work for these people.

Senator COLLINS. Mr. Rutledge, do you have concerns from your perspective as a State regulator about the growth in day trading?

Mr. RUTLEDGE. Yes, and we have several investigations under-way.

I think there are primarily two. One is licensure, that these people are licensed as a broker-dealer. They are in compliance with all the regulatory requirements for registration, such as margin, etc., and where they are promising get-rich-quick, anybody can do this—I have even seen, “Well, not knowing anything about investing is actually good. You can even be better at it if you do not know this.”

Senator COLLINS. Ignorance is an advantage?

Mr. RUTLEDGE. Yes. They are selling: Ignorance is good.

We are concerned about those firms who are basically touting nirvana to people who maybe have never invested before. We view them more as customers, rather than agents of the broker. They are giving them investment advice because they are making recommendations as to investment strategies when the people do not know the difference between a market order and a limit order, and they end up losing a lot of money.

One said, “Oh, all you need is \$25,000 to start.” Well, \$25,000 taken out of your 401(k) plan does not make you a sophisticated trader or investor. So we have concerns.

With respect to on-line trading, something we have begun to discover in our compliance audits of some on-line brokerage firms is third-party authorizations, where a customer opens up an account, but also gives authorization to a third party. Sometimes it is their financial advisor, and the financial advisor, we are finding out, is actually acting as an investment advisor that is not registered either with the Federal Government or with the State government as is required under Federal law. So that is another area of concern that people are trading on behalf of customers, using their on-line brokerage account. We are concerned about that, that there should be some obligation on the part of the on-line broker that if they know there is a third party authorized to trade in an account of one of their customers that they check out to make sure that the individual is registered either with the State government or the Federal Government to provide that investment advice.

Senator COLLINS. Yesterday, Professor Friedman testified about possibly expanding the suitability requirements to take into account the new on-line environment, which follows up with the point that you just made.

He pointed out that unsophisticated traders can easily invest in securities that are unsuited for their financial goals and their risk profiles, and that but for the broker-dealer’s firm’s trading facilities, the customer would be unable to invest in these inappropriate investments.

Do we need to take another look at the suitability requirements to make sure that they apply in an on-line environment? Presumably a broker would not recommend—or would recommend against some of the investments that the customer is able to do on-line, using the broker-dealer’s facilities.

Mr. Walker, what is your reaction to that proposal?

Mr. WALKER. I think historically, the suitability rules have applied where recommendations are being made, and oftentimes with respect to on-line brokerages, people are not looking for recommendations. They are simply plugging in orders which would raise questions as to whether the traditional suitability rules would apply in those circumstances.

However, in the day trading area, oftentimes recommendations are being made. Day trading firms recommending a strategy might be covered by suitability rules, and the NASD is taking a look at that. We have been having discussions with them about that.

Oftentimes, they are also recommending actual high-risk, very speculative securities, and certainly, I think the suitability rules would attach in those circumstances. So there is a review underway, and it is important that that take place because certainly that does provide very important protections to investors. That is a rule that I think the regulators all believe is a very important rule.

Senator COLLINS. Mr. Hildreth.

Mr. HILDRETH. It is sort of interesting. Last week, I was on a panel, a continuing legal education panel of securities lawyers, and interesting to me that they being the lawyers who are representing firms who are on-line, rather than wanting to somehow expand suitability, want to narrow it and say, "Look, if people are trading on-line, they are sending it themselves. They are putting it into our computer system. They are not talking to a broker. We should not have any responsibility to them." I tend to disagree with that and said so at the panel.

I do think that in some cases, we have to look at our current rules and say, "OK, maybe they need to be tweaked a little for the Internet." Pennsylvania took the lead, and I do not remember what year, on the issue of securities offering. If you put up a Web site and someone from New Hampshire goes into it, is that an offer to sell in New Hampshire? That was something specific to the Internet that it made sense that you had to tweak things, that you had to change things because of it.

I am not convinced certainly that we need to narrow the suitability rule or the know-your-customer rule, but I think that you are going to hear—or some people will hear from industry that they want relief, rather than expansion.

I think that there certainly still is a responsibility. Whether that person is making that sale, trade, through the computer, you need to know your customer and know whether that is a good trade. They may want to do it, anyway, but you bear a responsibility towards your customer.

Senator COLLINS. Mr. Rutledge.

Mr. RUTLEDGE. I could not agree more. I do not think there is any difference from walking into the door of a brokerage firm on Main Street in Maine than opening the virtual door to an on-line brokerage on the Internet, and if I went in with an order off of Main Street, I think I would get a different kind of reception. I would hope I would get a different kind of reception than I do if I just plug in and order on-line.

You have people who are investing on-line, who do not know the difference between market orders and limit orders. They are acting perhaps on tips that they saw in an on-line financial forum.

I commend the NASD for putting out a recent notice on volatility. I thought it was well done where examples were given of these volatile Internet stocks, and these were not penny stocks. These were bona fide Nasdaq NMS stocks that were very volatile, and people lost—I should not say lost, but they put in a market order. They thought the IPO was coming out at \$10 to \$12, which is normal, but the time they got their order executed, it was \$90 a share. They did not want it for \$90 a share, but they did not know any better to put in a limit order.

They can track. They know where the trading is. One company halted all on-line trading on that particular stock and said, “No, you have to call the registered representative on the phone. They could walk you through.” “Well, do you really want this? Do you want to put in a limit order rather than a market? If it is market, it might take time to execute. It could be vastly different than what the quote is right now.”

Just, again, educate the consumer. Educate the investor as to what the alternatives and possibilities are.

Another firm may use pop-ups, “Are you sure you want to do this? Right now it is a very volatile stock. It is going up. You are going to be responsible for what you put in. The difference between a market order and a limit order is”—“If you need help, click here or call our customer service line,” or whatever. I think those are very doable things. I do not believe that just because you offer an on-line facility, you can put your head in the sand as to your obligations to your customers.

A common theme throughout this hearing is the need for more consumer investor education, and I think that is something we can all agree on.

For my final question to you today, if you had one piece of advice to give investors who are going to use the Internet to make trades, what would your advice be?

Mr. Hildreth.

Mr. HILDRETH. I am not sure that it is any different from the Internet or somewhere else. If it sounds too good to be true, it probably is.

Senator COLLINS. Mr. Walker.

Mr. WALKER. I would agree with Mr. Hildreth. I would say the advice that I would give would be the same to people who are investing, and that is to get the facts and do your homework before you spend your hard-earned money.

Senator COLLINS. Mr. Rutledge.

Mr. RUTLEDGE. Investigate before you invest.

Senator COLLINS. I think that says it very well.

I am reminded of the investors town meeting that I hosted in Bangor, Maine, and Chairman Levitt’s advice was that you do not give your money to someone you do not know, and I think that applies whether it is in person or on the Internet.

The Subcommittee looks forward to continuing to work with you. You have identified today some areas where we need some legislative changes to tighten, for example, the area of micro-cap stocks, regardless of whether they are sold over the Internet or whether they are sold in other ways, to tighten the regulation and the authority that the SEC has.

We look forward and invite your further participation in this effort as we go forward. I very much appreciate the good work that you are doing and the cooperative effort that the States have established with the SEC.

In particular, what I do believe is the fundamental answer to this problem, which is to use the Internet just as the fraudsters are using the Internet, to reach more consumers, but with information on how they can better protect themselves.

So I thank you very much for your participation in this investigation and our hearings.

I also want to thank the Subcommittee staff, including Tim Shea, Lee Blalack, Elliot Berke, Smokey Everett, and Wes Phillips, as well as our support staff, Mary Robertson and Lindsey Ledwin. Their hard work in conducting this investigation and preparing these hearings helped us alert a lot of consumers, I believe, to the dangers or at least the perils of Internet investing.

I would also like to thank the minority staff and Senator Levin for their contributions to this effort.

The Subcommittee's hearing is now adjourned.

[Whereupon, at 11:05 a.m., the Subcommittee was adjourned.]

# A P P E N D I X

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STATEMENT OF  
**GALEN O'KANE**  
Ellsworth, Maine

Before The  
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS  
Hearing On  
SECURITIES FRAUD ON THE INTERNET  
March 22, 1999

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Madame Chairman and Members of the Subcommittee, thank you for inviting me to testify before you today. My name is Galen O'Kane and I'm pleased to be here to testify about my recent experiences concerning a shell company portrayed as an up and coming technology of the future. I am 38 years old and presently employed by Able Custom Yacht in Trenton, Maine since November of 1998. I graduated from the University of Maine with a degree in Electrical Engineering. My wife is also a University of Maine graduate with a degree in Mechanical Engineering. We moved to Boston, Massachusetts after I couldn't find an engineering job close to home.

My interest in investing in stocks began while I was working in Boston. I worked with a lot of older people that were getting ready for retirement and listened as they talked about their investments. Taking a commuter rail to work each day, I developed a habit of being the last one off the train so that I could gather up discarded newspapers like the Wall Street Journal, Investors Daily, and occasionally Barrons.

Sometime in 1989, I tied into Prodigy, which is an on-line service, for e-mail access and news updates. I soon discovered that I could track a list of stocks. Once I became comfortable with my knowledge of the market, and after obtaining my wife's approval, I began to invest approximately 10% of my income in stocks. I did most of my investing through the local Quick & Reilly office and was doing okay. Most of the stocks that I invested in were blue chip or well known companies.

With the addition of our two sons, my wife and I decided that the country would be a far better place to raise a family. We knew what living in a small Maine community was like, the "Mayberry of Andy Griffith" life, and missed it dearly. We moved to Maine because that's the way life should be. I gave up tracking stocks on line because the phone connections were just too expensive. After I was unable to obtain any kind of engineering job, I looked to retail and obtained one for minimum wage. In 1993, my son was diagnosed with Dermatomyositis -- a rare form of Muscular Dystrophy. I began to focus all my energy and resources into fighting and managing this terrible disease. By 1995, I couldn't keep a job because of all the medical attention my son required.

In the summer of 1997, things were looking better, so my wife and I tried to enter the work force. My wife landed a non-technical job at a communications outfit.

In 1997, we got on the Web to gain medical information about my son's illness and this got me more involved with stocks again on a day-to-day basis. I was buying and selling stocks more – and sometimes on-line. I did this in an attempt to offset my son's medical expenses. I continued to use my discount broker Quick and Reilly, which had been my broker from the beginning.

One day, while using Yahoo! Finance, I saw an advertisement for a free Internet newsletter, *The Future Superstock*, which was operated by an individual named Jeffrey Bruss. The site promoted a company called Electro-Optical, which developed and produced low cost, high quality fingerprint identification devices small enough to fit on a computer mouse. *The Future Superstock* promoted Electro-Optical as its stock pick of the month, and a few weeks later, as its stock pick of the year. I was impressed with the engineering and low unit-cost of Electro-Optical's technology and envisioned the product being used as a security device on everything from ATMs to door locks to computer mice. I invested approximately \$5,400 in Electro-Optical, purchasing 900 shares through my Quick & Reilly on-line account at slightly less than \$6 per share.

Based on the stock's performance, I felt it was behaving normally for market conditions. In late January 1998, I spotted a press release about Electro-Optical on Yahoo! announcing a huge purchase order. After reading the press release I became convinced that Electro-Optical and its product had tremendous growth potential. This was exactly the news I was looking for as my wife had just gotten fired because she couldn't get to work in Bangor because of a severe ice storm which made our country road impassable for 2 or 3 days. Here in Maine it is known as the "Storm of the Century." Just prior to the storm, we had to take James to New England Medical Center in Boston for a week. He was failing and at this point wheelchair bound, not eating – it wasn't a pretty picture. Feeling that this stock offered us a ray of hope for our financial situation, I immediately purchased 3,000 more shares at approximately \$6 per share. By this time, I had put over \$23,000 in the company. An article which ran in the *Bangor Daily News* in January 1998, entitled, "Computers to send fingerprints: New technology will cut identification time for Maine police," further validated my belief in Electro-Optical's product and the incredible possibilities it offered.

I started to spend less time on the Web due to my son's failing condition. In February 1998, while surfing the Internet, I came across a Barrow Street Research press release that discussed Electro-Optical. In the fine print, Barrow Street disclosed that it had been paid to promote the Electro-Optical stock. I had never noticed such a disclaimer on any of the prior press releases or Web sites that I had used to make my investment decisions.

In March 1998, I had to take my son, James, to the New England Medical Center in Boston for treatment. Before returning to Maine, I decided that I should stop by Electro-Optical's office, which was located just outside Boston. I was surprised when I was blocked from entering the building by the one employee that I saw. I looked into the building and was shocked to find that the building was completely empty. I expected to see an assembly line, equipment, and employees, but

there was nothing. I felt that Electro-Optical had completely misrepresented the nature of its apparently non-existent operation. I immediately put in an order to sell some of my shares. I ended up selling 1,900 of my shares for \$1.10 per share. Presently, my total loss is over \$20,000.

This experience reminds me of the old saying, "if its too good to be true, then it probably is." If one is looking to invest in a risky start up stock, then he or she should go visit the company first. The other advice that I would offer is to acquire advice from a REPUTABLE stock advisor. Many bulletin boards on the Web are full of information from sources that are not looking out for your best interest. I listened to a newsletter that appeared to be professional to me because they had a Web site, published a letter on a regular basis, had Web links to the stocks that they recommended, had other firms' recommendations (which I had never heard of, like Barrow Street Research), and appeared to know what they were talking about. Being an engineer, knowing a little bit about the technology and feeling that Electro-Optical had a viable product with countless uses intrigued me.

This was my first attempt at investing in a stock promoted on the Internet and it will be my last. I have continued to invest on-line, but I now turn to an investment advisor for advice on all of my investments. The Internet provided my family with invaluable information regarding my son's condition and today he is much better because of it. However, I also discovered the darker side of the Internet. Even after this experience, I still believe that the Internet does far more good than bad.

That concludes my oral testimony. Thank you again for allowing me to come here today to tell my story. Hopefully, it will help prevent others from falling into the same situation.

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STATEMENT OF  
**KRISTIN MORRIS**  
Berryville, Virginia

Before The  
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS  
Hearing On  
SECURITIES FRAUD ON THE INTERNET  
March 22, 1999

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Madame Chairman and Members of the Subcommittee - good afternoon to you all. I'd like to thank you for allowing me the opportunity to share my experience with you this afternoon. My name is Kristin Morris and I am a 34 year old Washington D.C. native. I have been married for almost four years and I had my first child in October of 1998. I am and have been employed for seven years with a small business, Advanced Computing Solutions, Inc. ACS, Inc. is a reseller to the Federal Government, selling PC computers and computer components.

I have always felt that I am very knowledgeable about computers and the Internet. At the time of my original purchase of stock on the Internet I felt very comfortable with this process. I first came upon Interactive Products and Services sometime in April of 1997. At the time, I was losing money in a utility stock which I had owned for several years prior and thought I needed to get out of that investment and try to be a bit less conservative with that money.

While surfing the Internet, I located a Web page through the "Webcrawler" search engine that maintained a list of different Initial Public Offerings being offered over the Internet. I was attracted to IPS because of its products and its claims.

What enticed me were several main items:

1. The products being offered by IPS made sense to me. These products were an Internet Telephone and a hand held keyboard/mouse that would work with "WebTV" and other like products.
2. I agreed with the owner of IPS, Mr. Bowin, and his suggestion that many people will purchase products like "WebTV" because of its cost. Computers are extremely expensive and are often more than the average person needs. Mr. Bowin went into this subject in detail. He discussed within the prospectus that many "service-oriented" and "blue-collar" workers would be more likely to



purchase Internet Television products before investing in a costly computer because of the cost savings to them.

3. Mr. Bowin included a link within his Web site containing IPS Press Releases announcing that they were in the process of working directly with companies such as "Microsoft," "Sun," "Apple," etc., to integrate IPS products to work with their software and their Internet TV hardware. These press releases stated that a deal was imminent and that he expected the stock to be worth somewhere around \$500 per share within the next five years. Of course, I saw this and figured I couldn't go wrong. I thought I was getting in on the ground floor of something "big."
4. Lastly, Mr. Bowin also included links within his Web site prospectus of camera-ready color photographs of the actual products themselves. These pictures were very impressive in their design. The prospectus gave detailed instructions on the products and how to use them. He even went on to claim, in his description of the keyboard, that the design was innovative and so easy to use that it would change the way we type in the future.

Though the Web site looked very impressive, I didn't rush immediately to buy the stock. Instead, I printed out the prospectus and had my husband read it over. We later agreed to sell my utility stock and invest \$1,000 in IPS. The minimum purchase of the stock was \$250. We knew of course we could lose this money if IPS did not succeed, but I never dreamed it was an elaborate scam and my money would be stolen.

Because the initial offering deadline was two weeks away when I first came across it, I only took two steps to verify the company. I called the long distance operator and asked for the telephone number of the address listed on the prospectus. I wanted to see if the number given to me by the operator matched the number in the IPS prospectus. This telephone number did match, so I then called the number and Mr. Bowin answered the call.

I asked several direct questions about IPS and its stock offering. I asked Mr. Bowin how close he was to meeting his financial goals. He said he was close but he might need to file for an extension and he told me this information was in the prospectus. I asked how the "talks" were going with Microsoft, Sun, Apple, etc. He informed me that things looked very good, but of course nothing was signed as of yet and anything could happen. Lastly, he said that he had filed for a U.S. patent on the keyboard and the telephone product, and this patent would be secured shortly. This information was also written within the prospectus.

Satisfied with these answers, I proceeded to fill out the application form and wrote my check for \$1,000 payable to "Interactive Products and Services". I sent the form and my check by certified mail. In a little over a week I received my certified mail receipt with Mr. Bowin's signature. Actually, I remember feeling a little odd about that. Since I have past experience working in the

corporate world, I found it strange that someone so "high up," for example, a President or CEO, would personally sign for mail. But after my initial suspicion passed, I decided it was no big deal.

A couple of months passed and the initial offering was over but I still had not heard from IPS or received my stock certificates. I called the IPS offices and once again reached Mr. Bowin personally. I inquired as to when the certificates would be mailed. He informed me that the offering had been extended through July 1997. He told me to make a duplicate copy of my application, resend it, and my stock purchase would be verified. I did as he requested. After this last telephone conversation with Mr. Bowin, I would never again be able to reach him and no one from his office would return my messages.

After several months I gave up. I knew I had been scammed. Out of sheer embarrassment, I never spoke of my experience to anyone. I wrote the money and the experience off to a lesson learned the hard way. Then, after many months had passed, I received a letter from the California State District Attorney informing me that Mr. Bowin had been arrested for fraud and I had been identified as one of his victims. I received another letter in December 1998 from the District Attorney stating that Mr. Bowin had been sentenced to ten years in a California State prison and the case was concluded.

My advice to anyone who is looking to purchase stock over the Internet is . . . DON'T. It is not worth the risk. An average investor, like myself, has no way to verify whether the stocks they are interested in are fraudulent or not. Until there is a solid, verifiable way to confirm the legitimacy of a stock – I must say . . . just don't do it. Today, I get an average of two e-mails a week offering stocks and "get rich quick" schemes. Many of these e-mails arrive without a return e-mail address. So, even if I wanted to, I could not report them. These e-mails usually direct the recipient to a Web site announcing a stock purchase plan. And, like the IPS Web site, many are extremely sophisticated and professional. I believe most of these stocks appeal to the small investor because they stress knocking out the stockbroker commissions and play on the past successes of Internet stocks. Anyone who even remotely follows the stock market knows of the incredible gains these types of stocks have made in the recent past.

I consider Internet Web pages to be a much more sophisticated approach to fraud than the over-zealous stockbroker who calls you at your office or home. Whereas you can always hang up on the over-zealous stockbroker, a Web page can be as professional as a legitimate prospectus. These Web sites can fool even the most experienced consumers.

I have no way to recover the money in which Mr. Bowin stole from me. But, I would like to close by offering my opinion, or better yet, my advice, which might help the average small investor such as myself. I suggest that the SEC provide an authorized banner to any legitimate stock offering to post on their Web page. This banner could provide a central telephone number the consumer can call to verify an offering by either the stock name or by a registration number. One quick phone call to an SEC operator to check the name or registration number and the consumer would immediately know if this were a legitimate security. I also believe this would inhibit any potential criminal activity due to the fact that their stock would, of course, not be registered with the SEC. If I had been given this option, I know I would not be sitting here in front of you today.

Again, thank you very much for allowing me the time to tell my story. I hope in some way your Subcommittee will find it useful. I appreciate what you are trying to do and I know it's a very difficult job you have in front of you. Thank you.

**Testimony of Thomas M. Gardner before the Permanent Subcommittee on  
Investigations of the United States Senate Committee on Government Affairs  
March 25, 1999**

My name is Thomas Gardner and I am a founder of The Motley Fool, Inc. of Alexandria, Virginia. It is a great honor for me to address the Senate Permanent Subcommittee on Investigations. Fools do not often get the chance to speak in the U.S. Senate.

I am particularly gratified to have the opportunity to address securities fraud on the Internet. I believe that the main factor that permits Internet securities fraud, indeed all securities fraud, is ignorance, and this sort of ignorance is exactly what we founded The Motley Fool to combat.

We founded The Motley Fool in 1994 to “educate, inform and amuse” the individual investor. Starting with a little newsletter, we now have internationally syndicated newspaper columns, books, a syndicated radio program, and online areas dedicated to the proposition that individuals can manage their money for themselves. We believe that technology, especially the Internet, allows people to obtain information that once was the exclusive property of Wall Street professionals, so that they can make their own financial decisions better than the professionals they previously relied upon.

Although we believe that individuals can and should make their own investment decisions, we don’t believe they should always do so alone. For example, we try to teach people how to think about investing, and we provide commentary and analysis about individual investments. In our online areas we provide access to news and data. Perhaps most importantly, the Internet makes it possible for individuals to join online

communities, so we manage online forums, such as message boards and real-time chat rooms, for people to share ideas, information, and experiences as they make their own decisions.

#### I. Bad Pennies

As this Subcommittee has previously learned, much of the securities fraud that takes place on the Internet apparently involves microcap, or “penny” stocks. Penny stocks are the stocks of small companies that are not traded on any exchange but trade “over the counter.” These stocks generally trade at less than five dollars per share, and they often go for less than \$.50. Journalists and analysts from major investment houses do not cover penny stocks, some of which do not need to make comprehensive electronic or hardcopy filings with the SEC, and because they do not trade on the exchanges, they often lack liquidity. Often the majority of the shares in a penny stock company may be held by company insiders or promoters.

Obviously, not all, or even most, microcap companies are fraudulent, and I’m not criticizing companies for failing to be Wal-Mart or General Electric, but the cheapness and obscurity of penny stocks makes them tremendous targets of fraud and manipulation. First, inexperienced investors may be attracted by the fact that they can buy many shares for little money. To take an extreme example, \$3,000 could buy only one share of Warren Buffett’s Berkshire Hathaway Class B stock, but it could buy six thousand shares of, say, “Marginal Technology Systems, Inc.” at fifty cents. After all, if the microcap stock goes up just fifty cents, the stockholder would double his or her money. Of course,

sheer number of shares and size of price movement are irrelevant, but excited, uninformed investors don't necessarily know that.

Second, without analyst or press scrutiny, investors may have few sources of information about a particular stock. They may thus be most vulnerable to seemingly independent "newsletters," either on paper or on the Internet, that tout stocks on behalf of their promoters.

Third, with little liquidity and a limited float (few shares available for public trading), it may not take much popular interest for a stock to move, even just a few cents, making it possible for the manipulators and touts to "dump" their stock at a profit, leaving the hapless buyer with worthless or near worthless stock.

For all of these reasons, The Motley Fool hates penny stocks. We try to teach people that penny stocks are risky and subject to manipulation. We do not cover penny stocks, except as horror stories. We will not open message folders for our community members to discuss penny stocks, and we will often remove posts about such stocks as being off-topic in our discussion folders. Our chat hosts will not discuss penny stocks. And when members of our community try to discuss such stocks on our message boards or in chat, our staff tries to warn other readers of how dangerous they are. Quite often, though, our warnings are unnecessary, as other readers warn their fellows before we even have a chance to do so. In excluding these stocks, we are certainly foregoing a line of business that would have a substantial readership, but we believe that providing a forum for discussion of such topics would be inconsistent with our message and unFoolish.

Penny stocks have given us great fun, though. I can't talk about them without mentioning Zeigletics, the penny stock that never was. In 1994, while my brother and I

were cranking out our monthly newsletter, we were also taking part in online discussions about stocks and investing. On Prodigy and America Online we would join message board discussion groups in the hopes of educating others and being educated ourselves. Our comments, though, were quickly drowned out by the overwhelming noise of penny stock hypesters screaming about Canadian mining companies at twelve cents a share and how we had to “GET IN NOW!!!!” Thus, on April 1st, we decided to play a practical joke by inventing a fictional company with a fictional product and a fictional ticker symbol. All we needed was a hypester.

Joey Roman was the name we gave to our penny stock superman. He launched a massive propaganda blitz, just like all the other hypesters. But Roman was better than all his competitors, even if he didn’t have a real company to hype. Joey Roman always bought all of the competitors’ stocks for a dime less, always pushed them up a few nickels higher, and he claimed to enjoy the gushing admiration of the entire penny stock world. He was, in short, a disgusting extreme.

We posted some fifty-odd messages on Prodigy over a one-week period that were read by thousands of investors. Roman hyped our fictional company, Zeigletics, Canadian manufacturer of linked sewage-disposal systems for the Central African nation of Chad, and he hyped them on our fictional Halifax Exchange.

In the first message we posted, Roman boasted of how Zeigletics was “a HUGE bargain!” because it was trading at 37 cents a share and the company has just introduced portable toilets (Zeig-Lo-Pots) along with bathroom accessories to Chad. Roman further hyped that “in Africa the name Zeigletics is virtually synonymous with toilets. The company recently sponsored the Sudanese equivalent of the Boston Marathon, where

hundreds of fans were waving plungers at the finish line!!!” In further messages we had Roman boasting of his success with lines like, “This baby just tripled, in ONE DAY!!!!...Our stocks never go down. If you haven’t bought Zeigletics yet (Halifax Canadian Exchange, symbol ZEIG.H), you’re no player at all.”

As you might imagine, we got a great many responses from investors all over the world. Some of them frantically posted questions and stated they’d contacted their brokers to try to buy shares, but those brokers had never heard of Zeigletics or the Halifax Exchange. The best message posted serves as the best possible closing to this little episode. It comes from a Mr. Hughes, whom we’ve never met, but he thinks as we do:

The point Joey Roman is making is pretty clear: It is so easy for a fast-talking hypster to establish a position in a low-volume stock, rattle off a bunch of crap that sounds plausible enough to convince a novice, let the price pop due to uninformed amateurs flying in, and sell into the rise, laughing all the way to the bank.

Dear people, learn to evaluate and think for yourselves. There are some legit stock pickers on this board, and good ones at that, but please check their records and do your own research before buying...

Zeigletics taught us several lessons, too. First, it demonstrated that there was an audience for humorous material about personal finance. Second, it showed that some people will believe just about anything they read, even if (or maybe because) they read it in an obscure corner of cyberspace. Third, it showed that many people have not learned how to make informed decisions about their money for themselves but will trade on tips, even ridiculous ones.

## II. The Problem of Securities Fraud On (and Off) the Internet

Ziegletics was a phony company, but as it wasn't taking anybody's money (although I hope it convinced some people not to give their money to penny stock promoters). I don't think you could call it an Internet stock fraud. I'm often asked whether securities fraud on the Internet is a significant problem. My answer is that securities fraud is a significant problem, and it takes place on the Internet, over the telephone, in restaurants, on the trading floors of the exchanges, and in boardrooms. As far as securities fraud is concerned, the Internet is just another medium through which people communicate with each other. Bad people have used all advances in communications, dating from the printing press, telegraph, telephone, and the radio, so it would be surprising if securities fraud was not taking place on the Net.

Securities scams on the Internet try to take advantage of the way the Internet makes it easy for people to communicate with many people quickly and cheaply. The best known scam, against which the SEC has conducted some high-profile enforcement actions, occurs when a seemingly independent, objective newsletter Web site or e-mail publication publishes favorable stories about a penny stock company that it has been paid to promote, but the publication does not disclose this relationship. Sometimes the company or its promoters even pay the hypesters with stock. After the stock has been sufficiently "pumped," its promoters usually "dump" their shares, leaving their victims with stock that is virtually worthless.

Other examples of securities fraud using the Internet have included:

- Individuals soliciting for investors in companies that don't really exist, or that exist on paper but are really scams. These con artists may use elaborately constructed Web sites that may look like real businesses. In one example, a



“start-up” called Interactive Products & Services used a sophisticated Web site to describe its “revolutionary” Internet technology (which didn’t work), based upon a Microsoft partnership (which had never occurred), key employees (who later denied any affiliation with the company), and SEC filings (which the SEC had never seen). Before the party ended, 150 people sent the company \$190,000, which the owner of the company spent on groceries, clothing, and stereo equipment, according to the SEC.

- Individuals or groups, including brokers or short sellers, may try to spread rumors or hype or smear companies through posts in Internet message boards or live chat rooms. I don’t know of any prosecutions or enforcement actions based solely on this sort of manipulation, but several companies have filed lawsuits alleging “cyber-smears.”
- Some hypesters use mass emailings of unsolicited commercial email, or “spam,” to spread the word about the stocks they promote. Several states, including most recently Virginia, have enacted laws to cut down on spamming, even when it is not fraudulent.

One of the most interesting characteristics of these investment scams is that they are so uninteresting. They are the same scams that criminals have been trying to perpetrate for decades, such as pumping and dumping, Ponzi schemes, stock touting and hyping, and rumor mongering. Sleazy operators have always tried to sell nonexistent companies, or worthless swampland, or the Brooklyn Bridge. Only the mechanism of transmission is new. Just as the telephone let con artists contact individuals in their homes, the Internet enhances these people’s reach. They can convey their fraudulent

message to thousands of people at a fraction of the cost that it would take to print and distribute a paper newsletter, and much more quickly than a thousand cold calls. Furthermore, people may be more likely to be taken in by Internet scams than by scams via telephone or personal contact because the Internet is essentially a text medium, and people may believe what they read.

At the same time, as we and the SEC's John Stark have noted, the Internet can also make it harder for malefactors to win out. Unlike telephone or personal contacts, Internet scams leave themselves open for rebuttal by others on the Net. It can be hard to hype a stock in a chat room, for example, if others in the room are challenging you to support your hype or give the source for your "facts," rebutting your arguments, or are warning your prey not to be preyed upon (which is one of the reasons why we assign hosts to our chat rooms and to monitor our message boards). Perhaps most importantly, though, Internet messages leave "footprints" -- they can be evidence of crimes and their creators can never be sure that law enforcement will not obtain them. Even the apparent anonymity of cyberspace can work against the would-be scammer. A few years ago *The New Yorker* magazine ran a cartoon stating "On the Internet nobody knows you're a dog." Well, nobody in cyberspace knows that you are a securities regulator, either.

### III. The Nightmare of Day Trading

The phenomenon of day trading, whereby individuals spend their days trading securities, often holding them for only hours or even minutes, is also not new. There have always been individuals who would spend their days outside brokerages, or call their brokers dozens of times a day. Nevertheless, the rise of Internet, deep discount

brokerages, and even day trading “parlors” have contributed to a massive increase in the number of people who, from their homes, offices, or rented desks and terminals, may spend their days buying and selling stocks they may know nothing more about than the stocks’ ticker symbols and share price. These day traders try to anticipate and take advantage of short-term movements in stock prices. Although full-time day traders are only a small percentage of individual equity investors, media reports indicate that the “profession” of day trading is growing rapidly. Day trading parlors are advertising and expanding their operations, and many books and seminars are available to help people embark on day trading “careers.”

The cheaper, quicker Internet trades certainly make day trading more feasible. With smaller brokerage commissions, day traders need smaller gains in order to be successful. And the faster a trade executes, the more likely that traders will execute their trades at the prices they expect.

I do not have any data to support me on this, but my intuition is that the rise of day trading may increase the incidence of attempts at market manipulation. Rumors may drive small, quick moves in stock prices; if a number of people believe a rumor that Amalgamated Widgets is going to buy Acme Mining Supplies, they may buy Acme, momentarily driving its price up. In a short while, information will emerge that no such merger will take place, but in that instant, the brief perception may be more important than reality.

It is important not to forget that the Internet didn’t invent either day trading or attempts at manipulation. But the sensitivity of short-term stock movements to rumors, half-truths, and undigested data would at least seem to give day traders incentive to

spread misinformation. That is one reason why The Motley Fool advocates a less exciting “buy and hold” strategy. Furthermore, day trading, with the constant attention that it requires, the constant risk, and the often-hopeless effort to predict the immediate future, seems like a particularly horrible way to make a living.

#### IV. Addressing Securities Fraud

##### A. Enforcement

In the last six months or so, the SEC has been particularly active in pursuing securities fraud on the Internet. In October 1998 and again in February 1999, they announced a series of high-profile enforcement actions against over fifty alleged fraudsters, most of whom were accused of promoting penny stocks over the Internet in return for undisclosed payments by those companies and their promoters.

These enforcement actions were exciting because they showed that the big cop was on the beat; cyberspace sleaze was going to be subject to the same rules as sleaze in “meatspace,” and fraudsters could not prey upon others with impunity. That the NASD and the North American Association of Securities Administrators are also active in addressing fraud on the Internet is also good news.

In addition to its enforcement actions, the SEC last month announced some regulatory amendments designed to increase the amount of information available to microcap investors and address some loopholes that penny stock issuers have used. I am hopeful that these reforms will help some investors make informed decisions about their investments, but they are unlikely, and were not intended, to eliminate the misconduct I’ve discussed today.

Enforcement and monitoring of the Internet (and the securities markets, including the microcap market) must continue, and should even be expanded, but it is never going to stop all evildoers, just as the regulators cannot catch all brokers who churn senior citizens' accounts or cold callers who sell naïve investors unsuitable securities. Similarly, the SEC's efforts to make more information available about individual microcap companies should help clean up the penny stock market, but won't solve everything. If government regulation and enforcement are medicine to cure the disease of securities fraud, then the public needs immunization, too. That immunization is education.

#### B. Education.

If people knew enough not to make investment decisions based upon tips, rumors, and touts and did their homework, they would not fall for most stock frauds on the Internet or otherwise. The SEC, among others, has been active in trying to educate investors so that they can avoid fraud and invest intelligently. Without criticizing the SEC, I can say that they have a gigantic task, as they face massive financial illiteracy, for a great number of Americans are never taught basic principles of personal finance either in school or at home. Many people graduate from high school without knowing how to balance their checkbooks, let alone understand the effects of compounding credit card debt (or investment returns) or how to plan for retirement.

Let me just outline a few other facts that I think outline the lack of fundamental financial knowledge in this country:

- Money continues to pour into managed mutual funds, including energetically managed funds with high fees that may turn over their portfolios like day traders,

even though over the last five years over 80% of them underperformed the market as a whole and the inexpensive index funds that mimic the market. In short, people are paying managers good money to reduce their returns.

- The average American family has \$5800 of credit card debt at 19% interest, even while increasing numbers of them are investing in stocks. At such an interest rate, people would have to make historically unprecedented returns over a long period of time to justify their investments. The best investment these investors could make would be to pay off their credit cards first.
- People routinely buy into investment “gurus” who promise returns that, over just a few years, would enable a small investor to purchase several European countries.

If we, as a country, are concerned about citizens’ ability to control their own financial futures, and we don’t want them dependent upon government handouts in their retirement years, this ignorance is a problem. It’s an opportunity for services with educational missions (like ours), which is good, but it’s also an opportunity for people promoting “get-rich-quick” schemes and other cons. That’s not good.

At The Motley Fool we preach a few, commonsense, unoriginal rules for people to avoid getting taken. You should do your own homework, learn about what you are investing in, and not act on tips, even from people you know, let alone anonymous strangers. If something sounds too good to be true, it probably is. If someone tells you that you must “ACT NOW” or lose a massive investment opportunity, you should probably skip it. Finally, the only surefire way to get rich quick is through inheritance, although through simple, systematic investment over time you can get rich slowly.

Unoriginal as these messages are, if people would heed them, securities fraudsters could hype, tout, rumormonger, and scam to their hearts' content without being able to manipulate markets or hurt anyone.

C. The Future of Online Trading

I am sure that online trading is the future of the securities industry. Actually, online trading is really the present of the industry, as more than half of discount trades are already online. Information technology, especially the Internet, gives individuals the power to communicate, work together, and take actions in ways that they never could before. Once people learn that they can make transactions without going through a human broker, that they can do so more cheaply, and that they can get enough information to help them make better decisions than their brokers did, they will continue to join the rush to online brokerages. I think this is a positive trend, both for The Motley Fool as a company and for individual investors (although not necessarily for the big, full-service brokerages).

Happy as I am about the land rush into cyberspace, I am especially glad that this committee is paying attention to what will happen to the investors once they arrive in the online world. If the Internet seems to be populated by hypesters, fraudsters, and touts, then 1) people will unfairly lose their money, and 2) they will lose faith in the public markets. Alternatively, if the securities laws and regulations that have made U.S. markets so much cleaner than other countries' are as vigorously enforced in cyberspace as they are anyplace else, and if we give people the educational and informational tools they need to make financial decisions for themselves and avoid swindlers, then the trends toward greater numbers of equity holders and increased connectivity can continue profitably.

Thank you for giving me the opportunity to address this Subcommittee. I would be happy to answer any of the Subcommittee's questions.

**STATEMENT OF PROF. HOWARD M. FRIEDMAN,  
UNIVERSITY OF TOLEDO COLLEGE OF LAW**

**Presented To The United States Senate Permanent Subcommittee On Investigations  
March 22, 1999**

I am Howard M. Friedman, Professor of Law at the University of Toledo. I have taught in the area of securities regulation for thirty years. For the last several years, my research has focused on the impact of Internet technology on securities regulation. My book, *Securities Regulation In Cyberspace* (Bowne & Co., 2d ed., 1998), examines in detail the regulatory and technological developments in the cyber-securities markets.

The Internet Revolution

Internet technology has dramatically impacted securities trading, capital formation, and regulation of the securities markets. While we sometimes refer to these developments as "The Internet Revolution In Securities Regulation," in fact the new environment is too complex to be described in a sound byte. In general, the widespread technological changes which have occurred in the operation and regulation of U.S. securities markets have strengthened their integrity, efficiency and international competitiveness.

The Internet revolution is an information revolution-- a revolution in the way information is collected, analyzed, retrieved, exchanged and disseminated. The securities markets are markets in information. Market participants determine securities prices by assessing information about a company's likely future earnings, information about both company-specific and general market risks, and information about the likely response of other investors to new developments. Securities regulation attempts to make certain that the stream of information remains accurate and unpolluted, that it continues to flow, and that all have equal access to its contents. The information-hungry securities markets are, therefore, natural early adapters of new technologies that make information more accessible.

The marriage of securities and cyberspace involves at least four increasingly interconnected components:

- The on-line filing of disclosure documents with the SEC through the EDGAR system and the availability to investors of the EDGAR data base through the Internet. SEC documents are also often made available on companies' Web sites.
- The electronic registration of broker/dealers and their personnel with the SEC, self-regulatory organizations and the states through the Central Registration Depository (CRD) system.
- A variety of electronic market-quotation, order-transmission, matching and trading systems, some operated by stock exchanges and the NASD, some operated by broker-dealers.



- A decentralized mass of financial and business information accessible through the Internet in the form of Web sites offering general financial news, corporate investor relations Web sites, bulletin boards and chat rooms devoted to financial discussions, and information made available on-line by broker-dealers and mutual funds.

#### Uses and Misuses of the Internet

The Internet is young. It takes a while to discover the most effective uses for new technologies. Slowly, the securities industry is discovering those areas in which the Internet can truly add value and effectiveness in the capital markets. In contrast, the industry is also discovering that, despite early expectations, the technology does not effectively displace more traditional mechanisms in other areas.

#### Direct Public Offerings

One of the disappointed expectations has been the use of the Internet for direct public offerings by issuers. Many imagined that the Internet would give issuers-- particularly start-up companies-- direct access to investors, and would permit them to bypass underwriting firms in raising capital. In fact, despite numerous attempts, few direct public offerings over the Internet have been successful. A Web site called Direct Stock Market, at <www.dsm.com>, furnishes companies making direct public offerings a centralized location on which to post their offering documents. In early March 1999, the Web site featured documents from 26 companies that were attempting to raise capital without the use of underwriters.

The Internet has not created revolutionary change in public offerings by start-up companies because investment banking firms add value as intermediaries that the Internet cannot replace. While it may be possible to "reach" investors through the Internet, it is much more difficult to convince them on-line to invest substantial funds in an unknown business enterprise. The underwriter adds its prestige to an offering and in this and other ways provides selling expertise. Moreover, investors prefer to invest in securities in which a trading market will develop so that they will be able to liquidate their holdings at a later date. Underwriters often serve as market makers to create such an after market. Attempts to create issuer sponsored bulletin boards and other non-traditional means of liquidity have not been particularly successful so far.

The Internet has been somewhat more successful at matching small businesses with venture capitalists. For example, ACE-Net, an on-line matching service created by the US Small Business Administration and a group of universities and nonprofit entities, at <ace-net.sr.unh.edu>, now concentrates on offerings under \$1 million made to accredited investors. Through Web sites like IPONET at <www.zanax.com/iponet>, brokerage firms assist issuers in finding accredited and sophisticated investors who may purchase securities in private offerings.

### On-Line Proxy Voting

In contrast to direct public offerings, a more successful use of Internet technology has been on-line proxy voting. Under the federal securities laws, publicly-held companies must disclose relevant information in soliciting proxies from their shareholders to vote their shares at the annual stockholders meeting. In the past, proxy cards were returned by mail. More recently, return of proxy cards through the Internet and by touch-tone telephone systems has gained in popularity.

As part of the proxy process, companies mail out proxy statements and annual reports to shareholders. Over 1700 companies have posted their annual reports on line. They may be accessed through <[www.annualreportservice.com](http://www.annualreportservice.com)>.

### On-Line Trading

A major success story of the Internet is on-line trading. Growing numbers of brokerage firm customers prefer to place buy and sell orders through the Internet. Those orders are then transmitted by the brokerage firm for execution to the stock exchange, to a market maker through the NASDAQ system, or sometimes, to an alternative trading system. Along with on-line trading, generally customers are given access to their accounts on-line. Trades are rapidly reflected in the on-line account statements.

On-line trading has been a success because here the traditional function of brokerage firms as intermediaries can be replaced by the Internet without any loss of-- and indeed with a gain in-- value. The Internet here has essentially replaced the telephone. A trade that was previously transmitted to the brokerage firm by a telephone call to a registered representative is now sent through the Internet. The brokerage firm's computer is always on duty to receive the order (though generally orders cannot be executed except during hours that the markets are open). A computer is never out to lunch or with a different client. While at a few peak trading times system overloads have prevented orders from being transmitted, those overloads probably appear less often than do "busy signals" on brokerage firm telephones during peak trading periods.

This is not to suggest that system capacity problems are not significant ones. They are because technology has changed investor expectations. Investors expect "busy signals" from time to time on the telephone. They have different expectations for on-line trading. The SEC and self-regulatory organizations should continue to work to assure that broker-dealer firms which offer on-line trading have systems that are designed to meet high-volume trading periods. It is during such periods of extreme market activity that it is particularly important to maintain investor confidence in the market system. Capacity break-downs undermine that confidence at the most critical periods.

### Day Trading

An unanticipated outgrowth of on-line trading is the rapid growth in day trading, that is trading by investors who buy securities and then resell them within a few days, or even within a few hours, in an attempt to take advantage of very small market price movements. In the past, day trading was limited to a small number of securities professionals. It has become available to average investors because of the confluence of two developments: on-line trading and extremely low commission rates that make it possible to profit from very small price changes.

I find the rapid growth of day trading to be a troubling development. First it creates excessive volatility in the price of shares. See Rebecca Buckman, *The Madness of Online Crowds: How 'Day Traders,' Computers Are Raising a Ruckus With Internet Stocks*, Wall St. Jour., Dec. 3, 1998, Pg. C1. This may mean that investors are unable to obtain order execution at the price currently quoted for the security. The NASD and its regulatory arm, NASDR, have taken a few steps to begin to deal with the problems raised by this type of volatility. In January 1999, *NASDR Notice to Members No. 99-11* suggested that broker-dealers furnish more disclosure to customers, and *NASDR Notice to Members No. 99-12* provided guidance on operation of broker-dealer order execution systems during periods of high market volatility. The NASD is also considering whether it should use trading suspensions to combat market volatility.

It requires extraordinary skill to profit from day trading on an extended basis. News reports suggest that for at least a significant number of day traders, their activities more closely resemble on-line gambling than on-line investing. Many of the dangers of gambling-- including the addictive element-- are present in unrestrained day trading. See Rebecca Buckman, *These Days, Online Trading Can Become an Addiction*, Wall St. Jour., Feb. 1, 1999, Pg. C1.

I would urge the SEC and self-regulatory organizations to examine carefully whether brokerage firms have in place appropriate criteria for screening those investors who are permitted to engage in day trading on-line.

### Customer Suitability

The Internet can easily displace a financial intermediary whose only role is to transmit information or receive orders. Traditionally, broker-dealers are more than order-takers. They also make investment recommendations to their clients. An important protection for customers is the requirement in self regulatory organization rules that recommendations must be suitable in light of the customer's investment objectives and financial circumstances.

With the rise of discount brokers, even before the advent of on-line trading, often investment advice was unbundled from order execution. Brokerage firm clients increasingly trade on the basis of their own research and not on the basis of their broker's

recommendations. Thus unsophisticated traders can easily invest in securities that are unsuited to the risks they wish to take or to the cash flow needs they might have.

In my view, one of the critical regulatory questions which needs examination is whether the suitability obligations now imposed on broker-dealers should be expanded in an on-line environment. Should broker-dealers be required to monitor the on-line trading of their clients and intervene when it appears that clients are using trading strategies that are grossly out of line with their articulated investment goals and financial situations, even though the trading has been undertaken without any advice or recommendations from the broker-dealer firm? But for the broker-dealer firm's trading facilities, the customer would be unable to engage in these inappropriate trading strategies. Just as an automobile owner should not be permitted to lend a vehicle to a person who does not know how to drive safely, the broker-dealer perhaps should be liable if it lends its trading facilities to one who does not know how to trade safely.

#### Information Overload and Misplaced Trust In Cyberspace-- The Predicate for On-Line Fraud

In the past-- before the Internet-- investors had access to limited amounts of information about investment prospects. Certain SEC documents were required to be sent to investors in hand, but many other filings were typically seen only by securities professionals. Investors obtained much information about potential investments in filtered form through financial advisers.

The Internet Revolution has dramatically changed this. Information previously available only to investment professionals is now available universally on-line at virtually no cost. Indeed more information than professionals of a bygone era had ever hoped to find is now available at the click of a mouse after typing a few key words into a search engine. However, more data can result in information overload. Even well-educated investors are seldom able to truly digest and analyze the meaning of the flood of raw information available on-line. Many investors, understanding this, welcome the newly available information, but continue to rely on investment professionals to assist them in interpreting it. However, others do not. They instead use the Internet to seek out investment recommendations and stock tips. They rely on postings from often-unknown sources who seem to have filtered through the mass of available information. This is the core source of much securities fraud on the Internet.

Identifying a skilled investment adviser is difficult under the best of circumstances. Several intersecting factors encourage many unwary investors to rely upon uninformed, and sometimes intentionally fraudulent, on-line advice. Often consumers are wary of "free" offers, knowing that one usually gets what one pays for. However, over the years investors have been conditioned to expect "free" investment advice. Full service brokerage firms offer such advice without an identifiable charge for it. Instead they cross-subsidize their investment research from the dollars generated as commissions when customers follow their investment advice.

When investors do not use price as a gauge of the quality of investment advice, what other indicators of quality do they have? A famous cartoon in the *New Yorker* portrayed two dogs sitting in front of a computer screen with one saying to the other, "On the Internet, nobody knows you're a dog." Similarly, on the Internet, Web sites that are "dogs" can easily look as "professional" as those of the most established firms. Moreover, at least in its early years, the Internet fostered a culture of "community" and "trust" that further encourages indiscriminating reliance by investors on all sorts of on-line investment recommendations.

The various sorts of Internet securities fraud have a single common thread. In each case, the victim relies on exaggerated recommendations or false information transmitted on-line by a person who will profit from the victim's reliance on the information. The profit may come from secret payments by others to the person promoting the stock, or may be realized when the stock price rises and shares secretly held by the person engaging in the promotion are dumped on the market.

#### Types of Securities Fraud on the Internet

Many so-called Internet stock frauds are traditional, garden-variety scams which have merely migrated to the Internet. For example, in October 1998 a California court convicted a promoter of 54 felony counts stemming from a stock offering conducted entirely over the Internet. The promoter raised some \$190,000 from 150 investors, and proceeded to pocket the offering proceeds and use them for such personal items as groceries, clothing and stereo equipment. See *Internet Stock Scam Results in Criminal Conviction of Promoter*, 30 Sec. Reg. & L. Rep. (BNA) 1543 (1998).

Other frauds, while resembling traditional ones, have taken special advantage of the capabilities of cyberspace. Much securities fraud-- be it in the 1920's or the 1990's-- involves dissemination of false information. The Internet is perhaps the most efficient and effective means yet devised for disseminating false information about potential investments. It is effective because

- it permits simultaneous transmission of information to thousands of investors around the world;
- it permits, and even encourages, information to be transmitted anonymously; and
- it discourages qualitative differentiation between different on-line sources of information.

#### Spamming

Bulk e-mailing ("spamming") permits promoters to reach thousands of persons at an extremely low cost. For less than \$300, software is available that will harvest thousands of e-mail addresses from Internet files and create mailing lists from them.

Similarly, bulk e-mail address lists can be purchased. One Web site offers a list of 10 million names for \$10,000.

In October, 1998, the SEC obtained by consent an injunction and the imposition of a civil penalty in California federal district court against a stock promoter who sent out several million e-mail messages under fictitious names recommending investment in the stock of two companies, without disclosing that the promoter would receive cash or securities as payment for touting the stocks. *SEC v. Francis Tribble and Sloane Fitzgerald*, SEC Litigation Release No.15959 (Oct. 27, 1998).

In another 1998 case, in Texas, the SEC obtained a preliminary injunction and an asset freeze after a company sent out e-mail messages to as many as 30 million prospective investors, falsely touting the company's business prospects in order to support the price of the company's publicly traded shares. A year earlier, the company's CEO had been released from prison on probation after conviction for securities fraud. The SEC charged that he had diverted \$100,000 in investors' funds to pay his probation fees and make victim restitution for his prior fraud. *SEC v. Remington-Hall Capital Corp. and Douglas T. Fonteno*, SEC Litigation Release No. 15943 (Oct. 22, 1998).

#### Misdirected E-mail Scams

A more sophisticated type of spamming is to send thousands of e-mails, each of which appears to have been inadvertently misdirected to the recipient. The Internet fraud watch coordinator for the National Consumers League reports a number of cases in which fraud victims received e-mail messages which appeared to be internal memos from well known investment firms. The memos contained supposed inside information designed to induce the recipient to invest in particular stocks. See Jeffrey Keegan, *Regulators Step Up Fight Against Internet Fraud*, Investment Dealers Digest, Aug. 10, 1998, Pg. 7.

#### Pump-and-Dump Schemes

Pump and dump schemes involve insiders, brokers or large shareholders who drive up the price of the stock of a company through circulating false rumors about pending developments. They then sell their earlier-acquired shares at these inflated prices. When the rumors prove to be untrue, the stock prices then decline. Internet bulletin boards devoted to the discussion of investments particularly lend themselves to this type of manipulation. Messages may be posted anonymously or under assumed names. A single person may post messages that appear to be from many different sources. Often a sense of "community" surrounds these bulletin boards and inspires trust among those using it. Messages may be posted without charge, can reach thousands of potential investors, and can substantially impact the stock's price.

In July 1996, a Florida company, Omnigene Diagnostics, was trading at \$1 per share. In October 1996, virtually identical messages signed with different names

appeared on AOL bulletin boards, claiming among other things that the company would have \$2 million in sales by the next year. The messages increased, and so did the stock price-- to over \$6.50 by mid-November. But then, again through the Internet, the truth strangely emerged. A disgruntled employee put on Omnigene's Web site information about its default on the license agreement that was critical to its business. Shortly after that, the SEC suspended trading in the company's shares and posted a notice of the trading suspension on the same AOL bulletin board on which the stock had been hyped. When trading resumed, the stock's price had dropped to 87.5 cents per share. See Leslie Eaton, *Internet Investing: Spotlight on Risk*, Intl. Herald Tribune, Dec. 6, 1996.

Normally pump-and-dump schemes are designed to cause artificial increases in the price of the company's shares. In at least one case, however, it was alleged that on-line discussion forums were used to circulate false information in order to drive the price of a stock down. Presstek Inc., a New Hampshire printing company, claimed that this scheme was carried out by short sellers who would profit by covering their short sales at the artificially depressed prices. See William M. Bulkeley, *Presstek Suit Alleges Short-Sellers Posted False Statements On-Line*, Wall St. Jour., Sept. 18, 1997, Pg. B5.

Anonymous information posted on Internet bulletin boards, however, is not always false. Indeed a study by Prof. Susan Watts of Purdue University, Prof. Mark Bagnoli of the University of Michigan, and Prof. Messod Benish of Indiana University presented at the 1998 Summer Symposium on Accounting Research at the Hong Kong University of Science and Technology suggests that anonymous forecasts appearing on the Internet were better predictors of the performance of technology companies than were the traditional analysts' forecasts appearing in the electronic First Call network.

Inexpensive software permits anyone to create a professional-looking Web site or newsletter on line. These may be used to tout stocks in pump-and-dump schemes. In November 1996, the SEC filed an enforcement action against a pump-and-dump scheme that had been carried out through an electronic newsletter, SGA Goldstar. The publisher of the newsletter was charged criminally, pled guilty, and was sentenced in federal district court in Virginia to two months in prison, two years of supervised release, and a fine of \$20,000. *US v. Melcher*, SEC Litigation Release No. 15490 (Sept. 12, 1997).

#### Affinity Group Frauds

Securities scams are sometimes targeted to particular groups of potential investors who share characteristics that make them likely securities purchasers. After World War I, for example, promoters of fraudulent investment schemes targeted people who patriotically had purchased Liberty Bonds. Today, promoters can use the Internet to locate affinity groups to whom a scam can be directed. In one Pennsylvania case, a company used its home page on the World Wide Web, among other means, to advertise its AIDS therapies. It then targeted the people interested in these therapies in a more conventional fraudulent offering of the company's stock. See Howard M. Friedman, *Securities Regulation In Cyberspace* Sec. 13.01[b] (2d ed., 1998).

### Adequacy of Present Anti-Fraud Laws

Existing statutes and rules prohibiting securities fraud appear to be sufficient to permit prosecution of most of the current Internet securities fraud. Indeed, in some ways Internet securities fraud is easier to detect and prove than fraud carried out through high pressure telephone sales. E-mail leaves a trail on disks. Enforcers can often discover fraudulent representations on Internet bulletin boards and Web sites by "surfing the Net" searching for words associated with fraudulent offers. On-line complaint centers make it easier than ever for investors to alert enforcers to problems. The SEC receives some 120 potential leads each day through its Web site.

The international reach of the Internet, however, does create enforcement hurdles. Continued strengthening of international enforcement cooperation will be critical to adequately respond to Internet securities fraud that may originate from an overseas server, or which may be directed from the United States to overseas investors.

### Preventing Victimization of Investors

While prosecuting securities law violators is important, it is even more important to take steps to prevent the victimization of investors. In examining what additional preventive efforts are needed to protect investors, we must remember that risk inheres in our securities markets. Innovation requires risk. The potential for high profits is inevitably accompanied by the risk of loss as well. This means that some investors will inevitably, and legitimately, suffer investment losses. Our securities laws are designed to assure that investors understand the risks they are assuming and to prevent fraudulent misrepresentations which make it difficult for investors to assess the true risk of their investments.

Today, I would suggest three approaches that may help prevent future victimization of investors:

#### (1) Revamping Suitability Obligations Imposed on Securities Professionals

Securities professionals-- broker-dealers and investment advisers-- are gatekeepers at the entrance to the securities markets. In an increasingly complex age, they should have heightened duties to screen out investors who are pursuing investment strategies that are clearly too risky for their financial situations and investment goals. While the kind of disintermediation encouraged by the Internet makes this more difficult, this should not be an excuse for their creating attractive nuisances-- on line trading opportunities that beckon the unsophisticated to participate in legitimate trading strategies, but ones which are unsuitable to the individuals' investment goals and financial situations.



### (2) Third Party Verification Mechanisms

Inexpensive software can make a fly-by-night financial Web site indistinguishable from those of well-established firms. Some type of third-party verification is needed to vouch for the legitimacy of particular sites. Securities regulators and industry groups should examine a program created by the American Institute of Certified Public Accountants for commercial Web sites. Its WebTrust program, at [www.cpawebtrust.org](http://www.cpawebtrust.org), provides for an audit of the business practices, transaction integrity and information protection policies of Web sites. A web site that meets the program's standards is issued a special seal to be displayed. The seal provides an e-mail link to the certifying CPA in case a customer encounters problems with a transaction. This program might be used as a model in the securities industry.

E-mail and on-line bulletin board postings can be made anonymously or under false names. These techniques are often used to circulate false information or to otherwise fraudulently promote investment opportunities. Digital certificates can be used to verify the identity of persons transmitting information on-line. Securities regulators and industry groups should explore the possible ways of using digital signature technology to prevent postings and e-mail messages that mislead investors about the source of financial information, predictions, projections or advice.

### (3) Educating Investors About Financial Risk

Why do many small investors accept on-line invitations to place their assets in high risk investments? Why are investors, small and large, willing to believe on-line promises of quick wealth? Why are they willing to believe rumors and tips posted by unknown informants? Publicity campaigns have alerted consumers to physical health risks posed by various environmental and nutritional factors. Similar techniques should be used to alert investors to risks to their financial health posed by unsafe investment practices.

A start has been made in this direction. For example, the Investor Protection Trust, in cooperation with the NASD and NASAA, has invested \$1 million in its "Financial Literacy 2001" program which is designed to increase the amount and quality of personal finance instruction in American high schools. See [www.fl2001.org](http://www.fl2001.org). Educational material is widely available on-line, including through the SEC's Web site. However, more significant investments in educational campaigns through the media will be required for the message to be disseminated effectively.



United States General Accounting Office

Testimony

Before the Permanent Subcommittee on Investigations  
Committee on Governmental Affairs  
U.S. Senate

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## SECURITIES FRAUD

### The Internet Poses Challenges to Regulators and Investors

Statement of Richard J. Hillman  
Associate Director, Financial Institutions  
and Markets Issues  
General Government Division



## Summary

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## Securities Fraud: The Internet Poses Challenges to Regulators and Investors

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The Internet is a global network of computers that ties together an estimated 153 million users worldwide and is providing the basis for a rapid expansion in electronic commerce. The rapid growth of Internet commerce is also significantly transforming the U.S. securities industry. For example, in 1998, approximately 22 percent of all securities transactions were conducted over the Internet compared with virtually no such transactions in 1995. According to industry observers, the Internet is popular among investors because it allows them to buy and sell securities from their personal computers, lower trading commissions, and gain ready access to market research.

Unfortunately, the Internet also provides fraudulent operators with a new and efficient medium to defraud investors of millions of dollars. Fraudulent operators find the Internet attractive because they can instantly communicate with millions of potential victims—via professionally looking websites, that appear to offer legitimate investment information, on-line newsletters, or e-mail—at far lower costs than traditional means of communication, such as the telephone. In addition, the Internet makes it easier for fraudulent operators to remain anonymous and commit crimes from nearly any location in the world and thereby evade U.S. regulatory and law enforcement authorities.

According to Securities and Exchange Commission (SEC) officials, as the Internet continues to expand rapidly, opportunities for securities frauds increase as well. For example, the number of E-mail complaints submitted to SEC, many of which allege potential Internet frauds, soared from about 10 to 15 daily in 1997 to between 200 and 300 daily in early 1999. According to SEC, the types of frauds committed over the Internet are generally traditional securities frauds. In one scheme, individuals who own a company's securities spread positive but false information about the company to increase investor interest and drive-up the price of the securities. The individuals then sell their securities at a quick profit, while later investors face large losses when the price of the inflated securities declines.

SEC has established an office to coordinate the agency's response to Internet fraud, provide training to SEC staff on monitoring the Internet, and develop guidance for SEC staff to follow when investigating Internet fraud cases. SEC has also (1) developed education programs to warn investors about the risks associated with Internet investing and (2) initiated 66 enforcement actions since 1995 to punish alleged perpetrators of Internet securities frauds. Nearly half of the 50 state securities regulatory agencies we surveyed have also developed specific programs to

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Summary  
Securities Fraud: The Internet Poses Challenges to Regulators and Investors

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monitor the Internet for potential frauds and penalize violators of state securities laws.

However, SEC and state regulatory programs to combat Internet securities fraud are new and face significant challenges that could limit their long-term effectiveness. In particular, the potential exists that the rapid growth in reported Internet securities frauds could ultimately place a significant burden on the regulators' limited investigative staff resources and thereby limit the agencies' capacity to respond effectively to credible fraud allegations. Moreover, the regulators face challenges in developing a coordinated approach to combating Internet fraud and educating a wide audience about the potential risks of Internet investing.

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Ms. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss Internet securities fraud and regulatory efforts to combat this growing problem. The Internet is a global network of computers that ties together an estimated 153 million<sup>1</sup> users worldwide and is providing the basis for a rapid expansion in electronic commerce. According to one industry research firm,<sup>2</sup> total U.S. business trade on the Internet reached \$43 billion in 1998 and is projected to soar to \$1.3 trillion by 2003. The rapid growth of the Internet is also significantly transforming the securities industry in the United States. An industry study,<sup>3</sup> reported that approximately 22 percent of all retail U.S. securities trades were conducted over the Internet in the first half of 1998, which was significant given that there was virtually no on-line trading in 1995. The industry study projected that the total number of on-line brokerage accounts will nearly triple from about 5 million in 1998 to over 14 million in 2002.

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<sup>1</sup>NUA Internet Surveys: How Many On-line? January 1999, Nua Ltd.

<sup>2</sup>U.S. On-line Business Trade Will Soar To \$1.3 Trillion By 2003." December 1998, Forrester Research, Inc.

<sup>3</sup>"Broker Watch." Investorguide.com, Inc.

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Securities industry observers and participants cite several benefits that the Internet provides to investors, which account for its growing popularity. In particular, the Internet permits investors to place buy and sell orders from the convenience of their personal computers and can lower trading commission fees charged by full-service brokers. By accessing broker-dealer webpages, investors can also gain access to stock market research that previously was not readily accessible to the investing public. Moreover, the Internet also allows investors to obtain immediate access to price quotes on securities or mutual funds.

Unfortunately, the Internet also provides several advantages to fraudulent operators who are using the new medium to defraud investors of millions of dollars. First, the Internet provides fraudulent operators with the ability to communicate electronically with millions of potential victims at a far lower cost than traditional means of communication, such as the telephone or mass mailings. Fraudulent operators can communicate with investors over the Internet through professionally designed webpages that may appear to offer legitimate investment information, on-line investor newsletters,

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chatrooms, or mass E-mailings (called "spam"). Second, fraudulent operators can use technology available on the Internet that makes it easier to hide their identity and thereby evade regulatory authorities. Third, fraudulent operators with Internet access can quickly initiate investment scams from virtually any location in the world thereby making it difficult for federal and state regulators to catch and prosecute violators or obtain compensation for victims.

As you requested, my statement will

- provide information about the incidence and types of securities frauds perpetrated over the Internet,
- describe Securities and Exchange Commission (SEC) initiatives to combat Internet securities fraud,
- provide information on the penalties that have been imposed on individuals found to have committed Internet securities frauds,
- present information from state securities regulators about state efforts to control Internet securities fraud, and
- identify potential challenges facing SEC and state regulatory initiatives in combating securities fraud over the Internet.

In summary, our work to date indicates that:

SEC and state regulatory officials generally agree that as the Internet continues to expand rapidly, opportunities for securities frauds are growing as well. One rough indicator of the growth in Internet securities fraud is the number of public E-mail complaints that are submitted to SEC's Internet website. The number of such E-mail complaints, many of

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which allege potential Internet securities frauds, soared from 10 to 15 daily in 1996 to between 200 and 300 daily in early 1999.

- According to SEC, the Internet provides a new medium to perpetrate traditional investor frauds, such as stock price manipulation schemes. However, some securities frauds appear unique to the Internet environment, such as the reported illegal copying of legitimate broker-dealer webpages for the purposes of defrauding unknowing investors.
- SEC has responded to the growing Internet fraud problem by, among other things, creating the Office of Internet Enforcement (OIE) to coordinate the agency's efforts to combat Internet fraud, providing training to SEC investigative staff on monitoring the Internet, and preparing guidance for SEC staff who are investigating potential Internet frauds. In addition, SEC has established programs to educate investors about the risks associated with Internet securities frauds, such as posting relevant information on its website.
- Since 1995, SEC initiated a total of 66 enforcement actions against alleged perpetrators of Internet securities frauds. As of February 1999, 32 of the 66 cases had largely been concluded, with violators generally required to (1) pay civil money penalties or (2) refrain from further violations of the securities laws. However, in 2 of the 32 concluded cases, state or federal criminal enforcement authorities prosecuted violators and obtained criminal convictions or prison sentences for 7 individuals.
- Over the past several years, nearly half of all state regulatory agencies have established specific programs to combat Internet frauds that violate state securities laws. Although many state agencies have initiated enforcement actions to prevent further violations of state law, officials from these agencies told us that in some cases violators may continue committing the fraudulent activity in other states.
- SEC and state regulatory agency programs to combat Internet securities fraud are new and face significant challenges that could limit their effectiveness in the long-term. In particular, the potential exists that the rapid growth in reported Internet securities frauds could ultimately place a significant burden on the regulators' limited investigative staff resources and thereby limit the agencies' capacity to respond effectively to credible fraud allegations. Moreover, the regulators face challenges in developing a coordinated approach to combating Internet fraud and educating a wide audience about the risks associated with Internet investing.



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Due to time constraints, we focused our analysis on SEC and state agency regulatory efforts to combat Internet securities fraud rather than other securities regulators that may also play a role, such as the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), and the Commodities Futures Trading Commission (CFTC). However, we did meet with officials from these organizations to obtain a general understanding of their regulatory efforts.

To meet our objectives for this work, we interviewed SEC officials from OIE, Division of Market Surveillance, Office of Investor Education, and the San Francisco District Office. We also obtained information from SEC on the outcomes of the 66 Internet securities fraud cases and reviewed the data contained in a random sample of 100 complaints received by the SEC and referred to SEC regional and district offices and other federal agencies. In addition, we met with officials from the Federal Trade Commission (FTC), the Department of Justice (DOJ), the Federal Bureau of Investigation (FBI), the White Collar Crime Center,<sup>4</sup> and the North American Association of

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<sup>4</sup>The National White Collar Crime Center is a unit within the U.S. Department of Justice, Office of Justice Programs, Bureau of Justice Assistance that provides services, such as information sharing, case funding, training and research to local and state law enforcement, prosecution, and regulatory agency members.

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Securities Administrators (NAASA) to discuss their roles in monitoring and combating Internet securities fraud. Finally, we (1) surveyed officials from all 50 state securities regulatory agencies to obtain their views on Internet securities fraud and efforts to control this growing problem and (2) met with officials from three on-line broker-dealers to discuss securities fraud and related issues. We did our work between October 1998 and March 1999 in accordance with generally accepted government auditing standards.

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**Regulators Report That  
Internet Securities  
Frauds Are Increasing**

There are no comprehensive statistics available on the incidence of securities frauds committed over the Internet. However, SEC and other federal agency officials we contacted said that Internet securities fraud is an emerging problem, which will likely grow as the use of the Internet continues to expand worldwide. The data available from state securities agencies also suggest that Internet securities fraud is increasing. According to SEC, the growing number of frauds committed over the Internet are types that are generally well-established in the securities industry. For example, in one common scheme, an individual who owns a large number of shares spreads positive but materially false information about a

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company over the Internet. This information drives up the company's stock price and the individual makes a profit from the sale of these stocks at the expense of other investors (commonly referred to as "pump and dump" schemes). We also identified some frauds that appear unique to the Internet environment, such as the reported illegal copying of legitimate broker-dealer websites for purposes of defrauding unknowing investors.

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**The Volume of Public E-mail Complaints About Internet Securities Fraud Suggests an Emerging Problem**

One rough indicator of the growth of Internet securities fraud is the number of complaints that SEC has received through its E-mail complaint system, which was established in June 1996. According to SEC, the public submitted about 10 to 15 complaints daily in 1996 via the E-mail system with the number rising to about 120 daily through September 1998. After SEC publicly announced a crackdown on Internet securities fraud in October 1998, SEC officials said the number of daily E-mail complaints soared to 200 to 300 daily and has continued to run about this range in early 1999. However, it is important to note that the volume of daily E-mail complaints submitted to SEC has several significant limitations as a measure of the extent of Internet securities fraud. For example, investors who are

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unaware that they have been defrauded would not likely submit E-mail complaints to SEC. In addition, SEC receives E-mail complaints that do not involve potential violations of the securities laws and some complaints may allege securities frauds that do not involve the Internet.

Other organizations and state regulatory agencies have also reported a significant number of public complaints regarding potential securities fraud committed over the Internet. NAASA—the organization that represents state securities regulatory agencies—received about 350 securities-related complaints involving the Internet over a 4-week period in October 1998, when NAASA first established an E-mail complaint system. Officials from securities regulatory agencies in 37 of the 50 states surveyed told us that they collectively received over 1,400 complaints related to potential Internet securities frauds last year. Generally, states reported receiving no such complaints in 1996.

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The Internet Provides a  
New Medium to Perpetrate  
Traditional Securities  
Frauds

SEC officials told us that the Internet provides a new medium for perpetrating fraudulent schemes that are well-established violations in the securities industry. Some of the fraudulent

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schemes are violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. For example, one commonly employed fraudulent scheme involves disseminating materially false information via spam, websites, on-line newsletters, or other means about small companies that have issued thinly traded securities. The transmission of materially false information—such as false statements about a company’s financial condition—over the Internet provides instant access to millions of potential victims at far lower costs than traditional means of perpetrating scams, such as the telephone or mass mailings.

According to SEC officials, one reason fraudulent operators spread false information about companies and their securities is to increase investor purchases of the securities, thereby increasing share prices. Frequently, the fraudulent operators already own a large number of these securities and are able to make quick profits by selling their securities as prices increase. By contrast, investors who purchase securities on the basis of false information may experience significant and rapid losses when the perpetrators sell their large positions. For example, in one case, SEC alleged that the defendants encouraged

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discussion about a company on Internet news groups and disseminated information that materially misrepresented the state of the company's technology, commercial viability, and existence of purchase orders for equipment. SEC further alleged that while continuing this scheme the defendants sold the company's securities for more than \$3 million.

SEC identified fraudulent operators who frequently provide compensation to, for example, on-line newsletters in the form of securities or cash to further these schemes. The newsletters publish the false information about companies or claim to provide "objective analysis" about the promising prospects for the securities without disclosing the compensation provided to the newsletter in exchange for publishing this positive information, a practice known as "touting." Touters often sell their shares in the company immediately following their recommendations, which is a deceptive practice commonly referred to as "scalping." In October 1998, SEC announced a nationwide crackdown on Internet touting, charging a total of 44 individuals or companies with engaging in the practice. In February 1999, SEC continued its Internet fraud crackdown and charged another 13 individuals or companies. We discuss

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SEC's enforcement activities in more detail later in this statement.

The sale of unregistered securities on the Internet is a problem reported among the states we contacted. In one case, Connecticut securities officials found that a prepaid cellular telephone company was advertising falsely over the Internet that it would sell limited liability partnership interests for a minimum price of \$5,000. Rather than using these funds to create a cellular telephone network in the Boston area as advertised, state regulators believed that the money may have been diverted to the company's owners. Other state securities regulators have reported the illegal sale over the Internet of stocks in offshore gambling enterprises, time travel technology, Hollywood movie theme restaurants, and air-conditioning and helicopter production companies. Financial losses suffered among victims of illegal securities sales reportedly ranged from \$18,000 to over \$100 million.

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	Other Internet securities frauds identified by federal and state regulators include initial public offerings and prime bank note schemes. <sup>5</sup>
The Internet Also Provides Opportunities for a New Type of Securities Fraud	Although the Internet generally provides a new medium to commit traditional securities frauds, it has also provided opportunities for some new fraudulent schemes. For example, officials from a licensed, on-line broker-dealer in California told us that in May 1997, the company's website was illegally copied. Information contained in the website—such as the company's name, address, and telephone numbers—were slightly altered or changed. The company CEO told us that the perpetrator who committed this scheme used the copied website to dupe foreign investors into sending funds to addresses listed. The company CEO also said that this scam went on for about 10 months, until the perpetrator moved on and copied another company's website and continued the scam.
	<small><sup>5</sup>In a prime bank scheme, perpetrators will offer investors the opportunity to buy notes, purportedly guaranteed by the world's top 100 banks, or "prime banks," which are fictitious financial instruments that allegedly offer high rates of return and safety.</small>



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Similarly, a Washington state securities official told us that a web site of a legitimate broker-dealer located in Seattle was copied and used to defraud foreign investors. The state official said that foreign investors were persuaded to purchase worthless stock certificates, and lost millions of dollars before the perpetrators decided to move on and copy another company's web site. Although the scam has not targeted U.S. investors, the regulator said that the agency decided to pursue the case because it has the potential to undermine the reputation of and confidence in the U.S. securities markets.

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**SEC Has Established a Unit to Coordinate Efforts to Combat Internet Securities Fraud**

SEC established the Office of Internet Enforcement (OIE) to coordinate the agency's response to increasing reports of Internet securities frauds.<sup>6</sup> OIE has several responsibilities, including developing policies and procedures for Internet surveillance, managing the E-mail complaint system, and providing guidance for conducting Internet securities fraud investigations. It has 3 full-time staff and about 125 volunteer staff in SEC headquarters and regional offices who work on a part-time basis to identify Internet fraud-related activities.

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<sup>6</sup>Although SEC established OIE in 1998, OIE's Chief has been responsible for coordinating SEC's response to Internet frauds since 1995.

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	<p>Through its Office of Investor Education and Assistance, SEC has also established education programs to inform investors about the risks associated with Internet securities frauds.</p>
<p>OIE Established to Coordinate SEC's Internet Oversight Activities</p>	<p>In 1998, SEC established OIE to coordinate the agency's response to growing reports of Internet securities fraud. OIE's three full-time staff are responsible for a variety of oversight and coordination activities. For example, OIE has developed a policy manual to guide SEC's Internet surveillance activities. The manual provides guidance to SEC investigative staff on monitoring Internet web pages to identify potential securities frauds. OIE's Chief told us that the manual also includes guidance on conducting Internet securities fraud investigations. In addition, OIE provides training to staff from SEC, state regulatory agencies, and international regulators, and coordinates some of SEC's Internet securities fraud enforcement cases.</p> <p>OIE also manages SEC's E-mail complaint system discussed earlier. OIE's Chief told us that staff review the E-mail complaints each day and decide the most appropriate action for each complaint. OIE's Chief also told us that some</p>

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complaints are discarded because many complaints may refer to the same potential Internet securities fraud, in which case only a few complaints are retained; or because SEC already has an ongoing investigation into the alleged Internet securities fraud. According to OIE's Chief, staff refer other E-mail complaints—which the staff believe generally represent promising leads on potential securities frauds—to staff in SEC's enforcement division in headquarters or regional offices.<sup>7</sup> OIE may also refer complaints that do not involve violations of securities laws to other regulatory agencies, such as FTC. During calendar year 1998, OIE referred about 800 complaints<sup>8</sup> to other SEC units, and to other federal regulatory and enforcement agencies.

SEC's enforcement division and regional offices provide about 125 staff who work part-time on various Internet fraud-related activities. For example, SEC staff may volunteer to spend about 1 to 2 hours a week identifying potential securities

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<sup>7</sup>OIE is also part of SEC's enforcement division.

<sup>8</sup>The potential exists that some of these complaints are not related to alleged Internet securities frauds. Based on our limited review of 100 complaints referred to SEC regional offices, and other federal regulatory and enforcement agencies, some of these referrals appear to relate to securities frauds, but do not involve the Internet. Other complaints appeared to be related to problems that customers have experienced with their broker-dealers. We did not systematically analyze these referrals to establish the percentage that were directly related to alleged Internet securities frauds.

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frauds. Or, the SEC staff may work on Internet securities fraud investigations that were initiated on the basis of referrals made by OIE. SEC staff also may obtain information on potential Internet securities frauds from sources other than OIE. For example, senior officials in SEC's San Francisco district told us that enforcement actions had been initiated against alleged perpetrators of Internet securities frauds on the basis of information received directly from the public or through their own Internet investigations.

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SEC Interagency  
Coordination Activities

OIE also has the responsibility to coordinate SEC's Internet oversight efforts with other federal regulators. OIE's Chief has met with officials in other organizations—such as NASD, NYSE, FTC, FBI, and the Secret Service—to discuss joint investigations pertaining to Internet fraud. As mentioned earlier, the OIE Chief said that OIE may refer E-mail complaints not related to violations of the securities laws to one of these organizations.

In addition, OIE has coordinated SEC's participation in Internet "surf days," which are generally organized by FTC. On these assigned days, staff from a variety of organizations—including

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FTC, CFTC, SEC, NAASA, or foreign regulators—are to spend time surfing the Internet to identify potential fraudulent practices. In the November 1998 “Investment Opportunity Surf Day,” agencies focused on identifying potential consumer financial frauds. The U.S. agencies that participated in the surf day found dozens of cases among the over 400 web sites reviewed that potentially promoted consumer frauds. FTC officials told us that the regulators typically send warning messages to persons who operate such websites. Although the regulators do not ordinarily take enforcement actions on the basis of surf day findings, FTC officials said that the identified websites are monitored to determine if they are complying with the warnings. Failure to comply could result in enforcement actions.

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**SEC’s Investor Education Programs**

SEC’s Office of Investor Education and Assistance has also developed education programs to inform investors about the risks associated with potential Internet securities frauds. According to its Director, SEC’s primary message to individual investors is that investment decisions should not be based solely on information obtained over the Internet given the potential for fraud. Rather, the SEC official said that investors

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should perform a number of independent steps to ensure the accuracy of information provided about a stock over the Internet. These steps include reviewing financial information about the company that may be available from independent sources, determining whether the company is in fact developing a technology as advertised over the Internet, and contacting companies that are alleged to be in the process of signing contracts with the company in question. Unless investors are willing to take such steps, the SEC official said that investors may want to avoid using the Internet as a basis for making investment decisions.

SEC has implemented several programs to advise the investing public about the risks associated with the Internet and potential frauds. For example, SEC's website provides investor education information, such as procedures that investors should follow when assessing the reliability of on-line newsletters. SEC's webpage also contains information about the risks associated with Internet bulletin boards, chat rooms and mass E-mailings. In addition, SEC (1) produces pamphlets that discuss the risks associated with Internet securities investing; (2) holds local "town meetings" across the United

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States to discuss investment risks; and (3) coordinates the "Facts on Savings and Investing Campaign" with federal, state, and international securities regulators. This campaign is designed to educate individuals on saving and investing. The campaign released a study in February 1998, entitled "The Facts on Savings and Investing," which, among other things, found that many Americans lack basic information about investing.

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**SEC Has Concluded About One-Half of the Internet Securities Fraud Cases Initiated Since 1995**

SEC initiated a total of 66 judicial and administrative actions since 1995 to combat Internet securities fraud, and about one-half of these cases had largely been concluded<sup>9</sup> by February 1999. Because SEC is a civil rather than a criminal enforcement authority, SEC enforcement actions result in civil penalties—such as fines—rather than prison sentences for persons who are found to have violated securities laws. However, state or federal criminal enforcement authorities have also initiated criminal proceedings in 2 of these 66 cases,

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<sup>9</sup>We defined cases as "largely concluded" when a final judicial or administrative action was brought against at least one party in the case. These final actions include civil fines, disgorgements, permanent injunctions, cease and desist orders, prison sentences for defendants, and any combination thereof. Some of the cases that we define as largely concluded may have other litigation pending against one or more defendants.

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which have resulted in criminal convictions or prison sentences for 7 individuals.

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SEC Has Statutory  
Authority to Pursue Civil  
Penalties

As provided by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Remedies Act"), SEC can seek civil money penalties in enforcement actions in federal district court or administrative proceedings against any individual or firm in the securities industry. The Remedies Act provides the district court with discretion in determining the civil penalty to be imposed in judicial proceedings. Depending upon the seriousness of the violation, SEC has the statutory authority to seek penalties that range from \$5,500 to \$1.1 million or up to 3 times the gross amount of the pecuniary gain to the defendant as a result of the violation.<sup>10</sup> Further, if the penalty is not paid within a prescribed time, SEC may request contempt proceedings in federal district court to compel payment.

According to SEC officials we contacted, the agency has limited staff and other investigative resources and is not able to pursue every credible allegation of securities law violations,

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<sup>10</sup> All penalties were increased to adjust for inflation as required by the Debt Collection Improvement Act of 1996. The increase was effective December 9, 1996.



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including Internet frauds. Thus, SEC officials from the San Francisco district said that agency investigations often focus on message cases that have a high degree of public notoriety. According to the SEC officials, "message cases" are intended to punish wrongdoers for egregious offenses and deter other potential violations.

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One-Half of All SEC  
Enforcement Actions Have  
Been Concluded

As of February 1999, a penalty or injunctive order had been imposed on at least one of the defendants in 32 of the 66 Internet securities fraud cases SEC initiated since 1995. Litigation was pending in the other 34 cases. In 21 of the 32 cases that have largely been concluded, violators were required to pay some form of civil money penalty. Specifically, violators were required to (1) pay civil fines, (2) disgorge illegally obtained profits to compensate defrauded investors, or (3) pay both civil fines and disgorgements. The civil fines that SEC imposed ranged from \$5,000 to \$4.4 million, while the disgorgements ranged from \$500 to \$4.4 million.

In nine other cases that have largely been concluded, a civil money penalty was not imposed on the violators. Instead, SEC primarily obtained a cease and desist order or permanent

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injunction to prevent further violations of the securities laws. In the remaining two cases, prison sentences or other criminal convictions were imposed by a state or federal court. According to DOJ officials we contacted, the department or the FBI would become involved in Internet securities fraud cases where there are widespread losses and many victims.

**Many States Also  
Reported  
Implementing  
Programs to Control  
Internet Securities  
Fraud**

We also obtained survey information from the 50 state securities regulatory agencies about state efforts to control Internet securities fraud and penalize state securities law violators.<sup>11</sup> Nearly one-half of the state agencies reported that they have implemented specific Internet securities fraud control programs over the past several years—such as surfing the Internet to detect potential frauds. Many states have also initiated enforcement actions to penalize individuals who use the Internet to violate state securities laws. However, some state agency officials report that state enforcement actions are not always effective because perpetrators prohibited from

<sup>11</sup>We conducted a structured telephone survey of securities regulatory agencies in all 50 states from December 1998 through January 1999. We asked primarily the Directors of these agencies, among other things, to describe whether or not their agencies had established specific programs to combat Internet fraud and the types of penalties imposed on violators. We obtained data about New York from an official of the New York Attorney General's Office.

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selling securities in one state can continue to sell securities in other states.

**Nearly One-Half of All the States Have Implemented Programs To Combat Internet Securities Fraud**

In 23 of the 50 states we surveyed, officials from regulatory agencies reported establishing specific programs to control Internet securities fraud and penalize violators of state securities laws. In 14 of these 23 state regulatory agencies, the programs generally consisted of one or more persons surfing the Internet using word searches, such as "investment," "finance," or the name of their state to detect fraudulent activity. Other states reported monitoring Internet bulletin boards, newsgroups, and chat rooms to identify potential securities frauds. The frequency at which these states reported conducting Internet monitoring varied widely among the states, ranging from one-half hour daily to 2 hours weekly to one time per month.

Regulatory officials from the other 27 state agencies that we contacted said they had not established specific programs to identify and combat Internet securities fraud. The officials cited several reasons for not establishing specific programs, such as inadequate technical expertise or, as in two cases, a

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lack of Internet access. In addition, officials from some of the other smaller state agencies said that the control of securities fraud on the Internet was the responsibility of the federal government and that their agencies would not be in a position in terms of available resources to handle the problem.

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**Applicability of State  
Enforcement Actions May  
Be Limited**

Officials from 31 of the 50 states we surveyed said that their regulatory agencies had initiated a total of about 190 enforcement actions against persons and companies accused of violating state securities laws through the use of the Internet. The number of enforcement actions initiated per state ranged from 1 to 22. The remaining 19 states had not initiated any enforcement actions related to Internet securities fraud.

Based on the results of our survey, states that have implemented specific Internet fraud securities control programs collectively initiated about three times as many enforcement actions as the states that did not have a program in place. About 146 enforcement actions were initiated across the 23 states that implemented programs compared with about a total of 48 actions that were filed across the 27 states that did

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not establish a program.<sup>12</sup> Nearly all of the enforcement actions initiated by the states resulted in warning letters, informal agreements, or the issuance of cease and desist orders. However, as discussed previously, state criminal enforcement authorities have pursued criminal cases as well.

An enforcement action brought by one state may deter persons or companies from committing fraudulent acts in that state, but it does not necessarily prevent persons or companies from committing the same scam through the Internet in other states. For example, a Pennsylvania securities official reported that the state took an administrative action against a company that disseminated Internet spam that called for investors to purchase interests in a trust and realize an 80 to 160 percent return on their investment. Although the administrative action prohibited the company from selling these interests to Pennsylvania residents, the company reportedly defrauded about 1,500 residents in other states who bought about \$3 million in interests.

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<sup>12</sup>Other factors, such as the size of the state's securities staff and the number of frauds originating from a particular state can also account for this difference.

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Moreover, California securities enforcement officials reported that if enforcement actions are initiated against companies located overseas, these companies tend to ignore the orders and continue to sell their securities. For example, the enforcement officials told us that an order was issued to a company located in England to stop the offer and sale of securities and convertible bonds in time travel ventures in the state of California. However, the officials said that the British company continued to fraudulently sell securities and bonds over the Internet, including to California residents.

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**Regulatory Challenges  
in Combating Internet  
Securities Fraud**

Although SEC and state regulatory agencies have initiated programs to combat Internet securities frauds, these programs are new, and it is too early to predict their long-term effectiveness. On the basis of our work, we identified several potential challenges that could limit the ability of these programs to protect investors from Internet scams. In particular, the potential exists that the rapid growth in reported Internet securities frauds could ultimately place a significant burden on the regulators' limited investigative staff resources and thereby limit the agencies' ability to respond effectively to credible fraud allegations. Another ongoing challenge is

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coordinating oversight among international, federal, and state securities regulators so that fraudulent operators are deterred from taking advantage of the fact that Internet frauds can be initiated from virtually anywhere in the world. A final challenge involves educating the investing public about the risks associated with Internet securities frauds. Since regulatory resources are limited, preventing investors from falling for Internet securities frauds in the first place may be the best way to contain the problem.

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The Rapid Growth of  
Reported Internet Securities  
Frauds Poses Challenges to  
Limited Regulatory  
Investigative Resources

The rapid expansion of the Internet and the growth of securities-related activities over the past several years pose potential challenges to SEC and state regulatory agencies to control securities fraud on the Internet. According to SEC's OIE Chief, the rapid expansion in E-mail complaints from 10 to 15 daily in 1996 to 200 to 300 complaints daily in early 1999 suggests that the agency may ultimately reach a point where it cannot respond to all credible allegations of Internet securities fraud. Given its present staffing levels, SEC officials said that the agency already tends to focus investigations on certain high-profile cases, including Internet fraud cases. We also note

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that over the past several years a significant number of SEC attorneys who are responsible for investigating Internet and other securities fraud cases have left the agency for higher-paying jobs in the private sector. For example, SEC reports that between 1996 and 1998 SEC's New York office lost 54 percent of its 137 enforcement staff and the San Francisco office lost about 40 percent of its 25 enforcement staff.

State regulatory officials we contacted said that their agencies have few staff allocated to investigate Internet fraud cases. For example, many state officials said that their agencies have no more than five staff to investigate and enforce all relevant state securities laws, so finding the time to adequately monitor the Internet to detect potential frauds can be difficult. Further, officials from some other state agencies said that specific programs to monitor Internet fraud have not been established in their organizations due to limited staff.



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Given that the Internet has millions of web-sites<sup>13</sup> and the regulators' belief that a large number of these sites, on-line newsletters and spams include schemes intended to defraud investors, SEC and state regulators may also face challenges in obtaining the technical capacity to comprehensively monitor the Internet and detect potential securities frauds. According to state regulatory officials, their staff mainly surf the Internet using commercial search engines and key word searches to detect potential frauds, which is a method that an official from the National White Collar Crime Center said is labor intensive and inherently inefficient. The official also said regulators should develop customized search engines to detect potential Internet frauds that could relieve staff of the labor-intensive search activities and thereby enhance regulatory efficiency. SEC's OIE Chief told us that use of customized search engines can help facilitate the detection of Internet securities frauds, but such devices are no substitute for the judgement of experienced, investigative staff trained in methods to identify

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<sup>13</sup>Latest estimates show that as of July 1998, the Internet consisted of about 37 million web sites. Source: "Internet Domain Survey," July 1998, Network Wizards <http://www.nw.com>.

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potentially fraudulent activities. Further, the OIE Chief said that developing such customized search engines could place demands on a regulator's limited financial resources.

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**Regulators Face Challenges  
in Maintaining a  
Coordinated Approach to  
Combating Internet  
Securities Fraud**

The global nature of the Internet increases the regulatory challenges of combating Internet securities fraud because the Internet for the most part does not recognize jurisdictional boundaries. Now, a fraudulent operator from anywhere in the world could solicit U.S. investors linked to the Internet. Even in the United States, fraudulent operators located in one state can use the Internet to defraud residents of other states, even though another state has taken action directing the operator to cease and desist. Jurisdictional issues are challenging because close coordination and cooperation among international, federal, and state securities regulators is required to prosecute violators and hopefully, deter additional Internet frauds.

The regulatory challenges associated with investigating overseas Internet securities fraud cases include obtaining evidence, convincing other governments to prosecute foreign

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entities and individuals, and ensuring restitution for victims. A 1997 report<sup>14</sup> by the International Organization of Securities Commissions (IOSCO),<sup>15</sup> argued that securities regulators need to establish well-defined mechanisms for cooperating with their foreign counterparts to respond to these challenges and deter Internet frauds. For example, IOSCO recommended that securities regulators develop policies and procedures to ensure the timely exchange of information about ongoing investigations of Internet securities fraud. IOSCO also stated that coordination should include sharing information about (1) Internet surveillance techniques, (2) questionable transactions that may represent potential Internet frauds, and (3) successful approaches to prosecuting Internet securities fraud cases.

State securities regulatory agencies face similar challenges in developing a coordinated approach to Internet fraud investigations and enforcement. As pointed out earlier, state

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<sup>14</sup>Report on Enforcement Issues Raised by the Increasing Use of Electronic Networks in the Securities and Futures Field." IOSCO (September 1997).

<sup>15</sup>IOSCO is an international organization of securities regulators—including SEC—whose mission is to promote global coordination in the regulation of the securities industry.

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**Statement**

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enforcement actions may have limited success because Internet securities frauds may be committed from out-of-state locations. Challenges facing states include working with other regulatory agencies to combat fraudulent schemes that operate across states, ensuring sufficient monitoring of the Internet by other jurisdictions, and obtaining necessary evidence to initiate enforcement action.

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**Regulators Face Challenges  
in Educating the Investing  
Public on the Risks  
Associated with Internet  
Securities Frauds**

According to SEC, investor education is a critical defense against Internet securities frauds given the fact that regulatory resources to combat the problem are limited. If investors are adequately informed about the risks associated with potential Internet securities frauds, then they will be less likely to fall victim to sophisticated scams. The investor education challenges facing regulatory agencies include identifying schemes or mechanisms that require further investor awareness and widely disseminating information about the risks associated with Internet in a timely and effective manner. While SEC has taken steps to educate the public that investment decisions should not be made solely on the basis of

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**Statement**

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information received over the Internet, ensuring that such warnings reach a wide audience is a difficult challenge. SEC's investor education initiatives to date—such as posting information on the SEC website and producing pamphlets—are relatively low cost and have a limited ability to reach a wide audience. For example, not all investors may be aware that SEC has posted investor education information on its website. Reaching a large audience with relevant investor information often involves conducting large media campaigns that could be expensive and may take a long time to produce results. SEC's capacity to educate investors and disseminate widely relevant information about the potential risks of Internet securities frauds may be limited. According to SEC, the agency's budget and staff resources directed to investor education have remained relatively stable over the past several years, so the agency's capacity to initiate large-scale media campaigns is limited.

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Statement

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In summary, Ms. Chairman we commend you for holding this hearing and thank you for inviting us to testify on our preliminary observations on Internet securities fraud and regulatory efforts to combat this growing problem. Hearings such as this are particularly useful because they provide a public forum for educating large numbers of investors that while the Internet has much to offer, there are potential risks as well. We look forward to working with you and your staffs in this important area.

Ms. Chairman, this concludes my prepared statement. My colleague and I would be pleased to answer any questions that you or Members of the Subcommittee may have.

Written Statement of Richard H. Walker  
Director, Division of Enforcement  
United States Securities and Exchange Commission

Concerning Securities Fraud on the Internet

U.S. Senate Permanent Subcommittee on Investigations  
Committee on Governmental Affairs  
United States Senate  
Washington, D.C. -- March 23, 1999

Chairman Collins, Ranking Member Levin, and Members of the Subcommittee:

I appreciate the opportunity to appear before this Subcommittee on behalf of the Securities and Exchange Commission ("Commission") to address securities fraud on the Internet and the Commission's efforts to combat such fraud. The Commission commends the Chairman, the Ranking Member, and the Members of the Subcommittee both for holding hearings in September 1997 on the important issue of microcap securities fraud and for convening these hearings on the related issue of on-line securities fraud.

I. **Introduction**

The Internet has dramatically changed how participants in the securities markets interact. In particular, it has provided new opportunities for investors to obtain a wide array of real-time information. However, at the same time, it has opened new avenues for securities fraudsters to swindle the investing public. By providing a medium for cheap, quick, and easy access to vast numbers of potential investors, in relatively anonymous

fashion, the Internet has become a favorite haven for many con artists. The Commission is well aware of the potential use of the Internet to perpetrate frauds, and we have been vigilant in developing pro-active and flexible responses to those abuses.

This testimony is designed to inform the Subcommittee of the types of securities frauds the Commission has witnessed on the Internet, to discuss the actions the Commission has taken in response, and to comment on future regulatory challenges in the wake of the recent proliferation of on-line brokers and day trading firms.

## **II. The Internet: A Revolution for the Investor**

Although still in its formative stages, the Internet has already changed the way investors approach the market. Internet usage continues to swell at a ferocious pace, resulting in a surge in the quantity and quality of information available to investors and rapid growth in trading on-line. At present, a reported 147 million people use the Internet worldwide, with approximately 77 million of them in the United States. Approximately 21 percent of all domestic households have access to the Internet.<sup>1</sup> Predictions are that there will be 300 million users worldwide by the end of the year 2000, and 720 million by the end of 2005.<sup>2</sup>

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<sup>1</sup> PR Newswire, Feb. 10, 1999 (reporting statistics provided by the Computer Industry Almanac Inc.).

<sup>2</sup> Id.



The Internet has brought significant benefits to investors, in terms of both cost savings and access to information. On-line brokerage firms generally charge a flat fee per trade, which today averages \$15.75 per on-line trade.<sup>3</sup> These low trading costs were virtually unthinkable only a few years ago. Full-service firms, whose fee is generally based on the size of the transaction, often charge more.<sup>4</sup> Retail investors are increasingly taking advantage of these low transaction fees.<sup>5</sup> According to one recent source, nearly 14 percent of all trades are conducted on-line.<sup>6</sup> This number understates the impact on the small investor; nearly 37% of all individual investor trades are done on-line, up from 17% in 1997.<sup>7</sup> Predictions are that half of all retail trades will be executed over the Internet by 2001.<sup>8</sup> Currently, there are approximately 5 million on-line trading accounts, and predictions of as many as 14 million accounts by 2002.<sup>9</sup>

The Internet also provides investors with enhanced access to information. At all times, investors can obtain market information over the Internet from virtually any

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<sup>3</sup> *Pop?*, U.S. NEWS & WORLD REPORT, Jan. 25, 1999 at 42.

<sup>4</sup> *Who Needs a Broker?*, BUSINESS WEEK, Feb. 22, 1999 at 113 (stating that it would cost between \$8 and \$29.95 to buy 200 shares on-line, while the same trade would cost \$116 at a full service firm). We caution, however, that investors should consider factors in addition to cost when selecting a broker, including the need for research and advice.

<sup>5</sup> In turn, more brokers are setting up shop on the Internet. Today, approximately 100 firms offer on-line brokerage, up from 33 in 1997, 20 in 1996 and a mere 12 in 1995.

<sup>6</sup> *Who Needs a Broker?*, BUSINESS WEEK, Feb. 22, 1999 at 113.

<sup>7</sup> Lynnley Browning, *The Rise of E-Wall St.*, THE BOSTON GLOBE, March 7, 1999 at G1.

<sup>8</sup> Julie Forster, *Online Trading Jars Full-Service Brokers*, CORPORATE REPORT WISCONSIN, January 1999 at 1 (citing stats supplied by Forrester Research).

<sup>9</sup> Jon Birger, *On-Line Brokerage Fights for Attention: Outspent, NBD Taps Novice Investors*, CRAIN'S NEW YORK BUSINESS, Dec. 21, 1998 at 4.

locale. The Internet places information at investors' fingertips previously available only to Wall Street professionals. With only a home computer, a modem, a phone line and an Internet service provider account, the investor can gather a wealth of investment information free of charge. For example, the Internet links investors to a growing number of services that provide immediate access to current stock quotations, price/earnings ratios, historical price and volume information, and company press releases. In addition, the Commission makes issuers' annual and quarterly filings available to investors free of charge from its Edgar database. Moreover, with the growing popularity of bulletin board systems, news groups and other on-line discussion forums, investors can communicate with other interested persons: existing and former shareholders, short-sellers, analysts, brokers, venture capitalists, and just about any other market participant. Further, some companies have begun to broadcast their analyst conference calls over the Internet,<sup>10</sup> an encouraging development in our fight against selective disclosure of significant corporate developments to the marketplace.<sup>11</sup>

Internet-based communication will soon serve as vital a role for investors as communication by the telephone or fax machine does today. Unfortunately, however, as investors explore the Internet for information and guidance to improve their investment

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<sup>10</sup> See *Internet Calls Can Reach the Ears of Small Investors*, BLOOMBERG.COM, Feb. 26, 1999.

<sup>11</sup> See Arthur Levitt, *A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading*, SEC SPEAKS, February 27, 1998 (expressing concern about a process whereby some companies release material information to analysts before the rest of the market).

decisions, they may also encounter some of the fraudulent scams being conducted on the Internet. As the Internet revolutionizes the way we communicate, fraud perpetrators have found it to be a convenient tool to communicate with investors. As a result, the Commission in general, and the Division of Enforcement in particular, have spent considerable resources in recent years surveilling and fighting securities fraud on the Internet.

### **III. Internet Fraud – Same Scams, New Medium**

The Commission began surveilling the Internet to detect fraud and other securities law violations in 1995, when the Internet first began to grow. While many indicia suggest Internet fraud is on the rise, the precise amount of such fraud cannot be quantified. Since 1995, we have brought 66 Internet-related cases, the majority during the last year. Last year, there was a substantial increase in the number of enforcement cases we brought that included an Internet component. This marks a trend we expect to continue.

Our four years experience patrolling the Internet leads us to conclude that securities frauds conducted on the Internet are the same basic frauds that have long plagued our markets. The cyber-scams we have seen break down into essentially three categories: offering frauds, market manipulations, and touting. While these scams are nothing new, the Internet facilitates their perpetration by virtue of its speed, low cost, and

relative anonymity.

*A. Offering Frauds*

These cases generally involve either phony or misleading offerings of equity, debt, and other securities. The securities involved run the gamut from the simple to the complex and esoteric. In some instances, unbeknownst to investors, the securities they think they are purchasing are non-existent. In other instances, the offering involves false and misleading statements concerning the issuer, e.g., exaggerated business prospects, inflated assets, etc. Often, these scams involve the theft of investor funds by the offering's promoters.

To date, we have brought 22 cases involving Internet offering frauds. This category of cases includes the following subsets:

Exotic Offerings — The Internet tends to lend an air of credibility to offerings, no matter how far-fetched. This point is exemplified by one of our earliest Internet cases in 1995, involving the fraudulent offer and sale of shares in two Costa Rican coconut plantations.<sup>12</sup> The promoter falsely claimed that one of the plantations had a major distribution contract with an American supermarket and that a bank had guaranteed investors' principal and 15

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<sup>12</sup> SEC v. Scott A. Frye, Lit. Rel. No. 15139, 1996 SEC LEXIS 3016 (Oct. 29, 1996).

percent interest. Shortly thereafter, in another matter, we took action against a promoter who was using mass electronic mailing (i.e., "spam") to solicit investors for a proposed eel farm.<sup>13</sup> The promoter promised investors a "whopping 20% return," claiming that the investment was "low risk." The promoter also distributed fabricated endorsements of the investment from fictitious investment advisers.

Fraudulent exotic offerings continue. In August 1998, we charged two defendants with fraudulently raising approximately \$2 million from 152 investors nationwide for purported investment in a virtual casino web site.<sup>14</sup> We alleged that only a portion of the funds raised were used to build the web site for the casino, the remainder went to undisclosed and undetermined expenses, including salaries, payments to family members, and to the purchase of a Mercedes Benz sport utility vehicle. In January 1999, both defendants were permanently enjoined by a federal court from violating the law and ordered to disgorge a total of \$288,892.

We have also witnessed over time that these schemes tend to offer more complex securities. It appears that fraud artists believe that the more exotic or complex the security, the more likely they are to pique investor interest. For example, last month we secured emergency relief -- including a preliminary injunction and an asset freeze --

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<sup>13</sup> SEC v. Daniel Odulo, Lit. Rel. No. 14616, 1995 SEC LEXIS 2186 (Aug. 24, 1995).

<sup>14</sup> SEC v. Internet Casino Sports Gaming, LLC, Lit. Rel. No. 16025, 1999 SEC LEXIS 112 (Jan. 13, 1999).

against a Dallas company and its president who we claim engaged in a foreign currency trading scheme.<sup>15</sup> We allege that the defendants raised at least \$3.7 million from at least 40 investors by selling investments in foreign currency transactions designed to achieve very high rates of return with limited risk. The Internet was used to market the investments. We further allege that only \$600,000 was so invested, while the remainder of the funds were misappropriated.

Pyramid and Ponzi schemes — These two classic fraudulent schemes have found their way onto the Internet. In a “pyramid” scheme, participants attempt to make money solely by recruiting new investors to the program. When new investors and capital can no longer be found, the scheme collapses, with those not fortunate enough to have cashed out suffering the loss. In a “Ponzi” scheme, funds from new investors are secretly used to pay prior investors, with promoters skimming off the top for themselves.

The Internet played a major role in one of the largest pyramid schemes ever uncovered by the SEC. In March 1998 we obtained emergency relief against several defendants who had raised more than \$150 million from approximately 150,000 investors.<sup>16</sup> We allege the defendants used an Internet web site and postings on several different discussion forums to sell interests in what was in fact a pyramid scheme. While

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<sup>15</sup> SEC v. Forex Asset Management, LLC, Lit. Rel. No. 16055, 1999 SEC LEXIS 262 (Feb. 8, 1999).

<sup>16</sup> SEC v. International Heritage, Inc., Lit. Rel. No. 15672, 1998 SEC LEXIS 434 (March 17, 1998).

the company claimed that it was product driven, the primary way sales representatives made money was by recruiting other sales representatives. The company concealed the fact that it was being operated as a pyramid scheme, while profiting by requiring each new sales representative to purchase a "business kit" for \$100.

In March 1998, we obtained injunctive relief in a case which illustrates an on-line Ponzi scheme.<sup>17</sup> A Central District of California court enjoined four defendants for operating a Ponzi scheme involving investment contracts for the sale and leaseback of automated teller machines. The defendants offered the ATM program over the Internet and raised over \$3.49 million from 132 investors. Defendants were ordered to disgorge over \$595,000 in ill-gotten gains and to pay a civil penalty in a like amount.

Affinity Frauds — These are frauds targeted at specific racial, religious, or ethnic groups. Here, too, we have witnessed the migration of similar type of fraudulent conduct to the Internet. For example, in July 1998, we obtained injunctions and a \$4 million disgorgement order in an Internet fraud targeted at African-Americans.<sup>18</sup> Defendants raised \$4 million from approximately 2,000 investors through false claims that they were operating a bank when, in fact, no bank existed. An Internet web site was used to solicit investors. The Internet offers a variety of ways to conduct affinity frauds, such as by

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<sup>17</sup> SEC v. Western Executive Group, Inc., Lit. Rel. No. 15134, 1996 SEC LEXIS 2999 (Oct. 23, 1996).

<sup>18</sup> SEC v. First Zurich National USA, Lit. Rel. No. 15634, 1998 SEC LEXIS 169 (Feb. 3, 1998)..

advertising on a web discussion forum dedicated to a particular racial, religious, or ethnic group.

Prime Bank Fraud — In recent years, the incidence of so-called “prime” bank schemes has been on the rise.<sup>19</sup> These instruments purportedly take the form of notes, debentures, letters of credit, and guarantees. The schemes involve promises or guarantees of unrealistic rates of return. Typically, no such securities exist and the names of well-known domestic and foreign banks are improperly used to add credibility to the offering. Our early days of Internet surveillance detected this type of fraud as well. For example, in August 1995, we obtained emergency relief against defendants who raised \$4 million in a “prime” bank scheme which took advantage of the Internet.<sup>20</sup> Defendants used various methods to advertise the offering, including postings in the classified section of a major on-line service provider.

#### B. Market Manipulation

Market manipulation most often involves attempts to drive up a stock’s price in the secondary trading market by creating demand through the dissemination of false and misleading information. The manipulator normally owns shares in the company’s stock

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<sup>19</sup> See SEC Office of Investor Education and Assistance, Investor Alert, So-Called “Prime” Bank and Similar Financial Instruments (available at [www.sec.gov](http://www.sec.gov)).

<sup>20</sup> SEC v. Gene Block, d/b/a Block Consulting Services, Lit. Rel. No. 14711, 1995 SEC LEXIS 3006 (Nov. 2, 1995).



and sells out after the price is artificially inflated. When the manipulation is complete, the share price normally collapses, victimizing those who purchased during the scheme at higher prices. This form of manipulation is commonly referred to as the “pump and dump.”

Since a key element of a manipulation is widespread dissemination of false and misleading information, the Internet has proven to be a vehicle of choice for those who would manipulate the market. With a few keystrokes and a click of a mouse, information can be widely distributed over the Internet through postings to web sites, postings on electronic bulletin boards, via spam, as part of chat room discussions, or through multiple other avenues. While the Internet offers important benefits to investors, unfortunately, it does not come with a built-in mechanism that separates the tainted information from that which is truthful and reliable. In addition, investors often do not know the identity and background of the person with whom they are communicating. The cost of disseminating information over the Internet is less than running a traditional “boiler room,” which entails the cost of office space and numerous salespeople and telephone lines. The speed and efficiency of the Internet also allow information to be disseminated much more broadly and quickly than conventional boiler room methods. Accordingly, the Internet could soon replace the boiler room as the primary mode for conducting market manipulations.

We have brought 18 cases involving manipulations taking place on the Internet.

The typical Internet manipulation involves “microcap” stocks.<sup>21</sup> As discussed during this Subcommittee’s September 1997 hearings on microcap fraud, these stocks are particularly susceptible to manipulation due to the confluence of their low price, lack of reliable and current issuer information, and relatively small number of shares trading in the market.

A classic example of an on-line manipulation is our case against Comparator Systems Corp. The company and several of its officers and directors disseminated misleading information on the Internet regarding the financial status of the company as well as the company’s purported proprietary interest in a fingerprint identification device. Comparator had, in fact, stolen the fingerprint technology. Comparator was the subject of tens of thousands of Internet bulletin board postings where the misleading information was discussed. During the time of the manipulation, Comparator stock, normally trading in nominal amounts, broke the Nasdaq one-day trading volume record with 123 million shares traded. At its height, the company’s market capitalization was inflated to over \$1 billion. Defendants sold millions of dollars of Comparator shares through accounts in the names of other persons.

To date, the Commission has obtained a trading suspension, permanent

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<sup>21</sup> Although “microcap” is not a term defined in the federal securities laws, microcap companies are generally thinly capitalized companies whose securities trade in the over-the-counter market, primarily on the OTC Bulletin Board or in the pink sheets.

injunctions, and officer and director bars against several defendants. We also sanctioned Comparator's accounting firm. The litigation and our investigation is continuing.

A second massive market manipulation conducted on-line involved the stock of Systems of Excellence ("SOE"), a company purportedly in the business of manufacturing and distributing video teleconferencing equipment. The mastermind of the scheme, Charles Huttoe, secretly distributed millions of SOE shares to family members and entities he controlled. Huttoe then made corrupt payments to the publishers of an on-line newsletter, SGA Goldstar, to recommend the stock and proceeded to sell his shares at an inflated price. The scheme allowed SOE to obtain a market capitalization of \$350 million without ever selling a product. The Commission brought 11 enforcement actions charging 19 defendants and 12 relief defendants. We also worked closely with the U.S. Attorney's Office for the Eastern District of Virginia to prosecute Huttoe and others involved in the scheme. In January 1997, Huttoe was sentenced to 46 months in federal prison. In total, six guilty pleas have been entered in the case.<sup>22</sup>

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<sup>22</sup> For other significant cases where we alleged on-line market manipulations, see: SEC v. Electro-Optical Systems Corp., Lit. Rel. No. 39750, 1998 SEC LEXIS 751 (Apr. 21, 1998); SEC v. Environmental Chemicals Group, Inc., Lit. Rel. No. 15183, 1996 SEC LEXIS 3351, (Dec. 11, 1996); and SEC v. Remington Hall Capital Corp., Lit. Rel. No. 15493, 1998 SEC LEXIS 2289 (Oct. 22, 1998).

C. *Touting*

Investors presented with information and analysis concerning a potential investment have a right to know whether that information and analysis is the product of objective and independent research, or whether, in reality, the issuer simply “bought and paid for” it. The average investor would find the fact that the information or analysis was “paid for” to be highly significant, because he or she would be likely to consider such information less reliable than independent, disinterested analysis. Section 17(b) of the Securities Act is the antifraud provision that directly addresses this concern. Section 17(b) makes it illegal to tout any security for compensation received from an issuer, underwriter, or dealer, without fully disclosing the nature, source, and amount of that compensation.

Illegal touting on the Internet (and elsewhere) is a major concern of the Commission. The wealth of information available over the Internet aids investors and the markets only to the extent it is credible and reliable. Our surveillance of the Internet, particularly during 1998, made clear that numerous promoters were flouting the requirements of Securities Act Section 17(b). Our Office of Internet Enforcement<sup>23</sup> directed and oversaw a coordinated surveillance effort that resulted in our identification of numerous situations where there was either non-disclosure or inadequate disclosure of

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<sup>23</sup> For a discussion of the work of this Office, *see* pages 18 - 23 below.

compensation received by the touter.<sup>24</sup> Because the problem appeared to be widespread, we believed a strong enforcement response in this area was required. Accordingly, we decided that a “sweep” approach would work best, coordinating multiple investigations to culminate in the filing and announcement of numerous cases on the same day. This approach maximizes the visibility and deterrent effect of our enforcement efforts.

*The “Sweep”*

The Commission's first nationwide Internet fraud sweep (the “Sweep”) was announced October 28, 1998. We filed 23 enforcement actions against 44 defendants and respondents across the country for committing fraud over the Internet and deceiving investors around the world. The Sweep involved actions filed by the SEC's home office